The Capital Market/Spatial Market Divide

Presentation to
NAIOP 2008 Forum

by
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October 21, 2008
Presentation Overview

• Introduction

  – Part I: Macroeconomic Conditions
  – Part II: Capital Markets
  – Part III: Real Estate Fundamentals

• Challenges, Issues and Opportunities
The Definition of Real Estate

What is Real Estate?

Artificially delineated space over time with a fixed reference point to the earth......

Dr. James A. Graaskamp

Money-time

Space-time
Three Major Attributes of Real Estate

*Three major attributes of real estate . . .*

- $L,$
- $L,$
- $L.$
Three Major Attributes of Real Estate

Three major attributes of real estate . . .

- \( L \), \( \setminus \) \( \ldots \ldots \text{vulnerable,} \)
- \( L \), \( \setminus \) \( \ldots \ldots \text{vulnerable,} \)
- \( L \), \( \setminus \) \( \ldots \ldots \text{vulnerable.} \)
Political Preferences and Prognastication

• Which ticket do you personally prefer?

<table>
<thead>
<tr>
<th>Ticket</th>
<th>Count</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barack Obama/Joe Biden</td>
<td>12</td>
<td>21%</td>
</tr>
<tr>
<td>John McCain/Sarah Palin</td>
<td>36</td>
<td>64%</td>
</tr>
<tr>
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<td></td>
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Total 56 respondents

• Which ticket will win?

<table>
<thead>
<tr>
<th>Ticket</th>
<th>Count</th>
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<tbody>
<tr>
<td>Barack Obama/Joe Biden</td>
<td>53</td>
<td>88%</td>
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<td>John McCain/Sarah Palin</td>
<td>7</td>
<td>12%</td>
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<td>0%</td>
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Total 60 respondents
Part I: Economic Growth & Recession?

GDP was up 3.5% in 2nd Q, but…

How long?

NAIOP Forum

2Q-3Q

Heading into major recession?

Source: Moody’s Economy.com
Unemployment Rates

Employment to improve early '09?

How Bad?

• State & Local Government
• Technology, retail
• University Professors???

How Widespread?

Who’s Next?

Source: economy.com
Business Indicators & Business Confidence

Corp Balance Sheets OK?
Exports will propel economy

Inventories/Shipments

Source: Haver Analytics

Inventories
Shipments

Source: economy.com

Business Confidence

Corporate profits, % change year ago

Source: Haver Analytics, Census Bureau/Haver Analytics

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Global Contagion: Diffusion of Credit Innovation

Most Affected Regions

- **Netherlands** to inject €10 billion ($13.4 billion) into ING Groep NV
- **Germany** worked out details of a €500 billion rescue package
- **Sweden’s** financial stability plan, includes $206 b bank guarantee
- **South Korea’s** $130 b guarantee and $30 b infusion Korean banking
- **Iceland's** banking system essentially collapsed in the past month
- **China's** economic growth slowed more sharply than expected
- **Russia's** financial markets face rising interest rates and a liquidity shortage.
- **Japanese** economic stimulus package worth $107 b.

Source: economy.com
Stock Market: Now and Then

**NAIOP on**

- **Where bottom?**
  - 9000 - 10000
  - 8000 - 9000
  - 7000 - 8000
  - 6000 - 7000
  - 5000 - 6000

- **Where in 2 years?**
  - 14000 - 16000
  - 12000 - 14000
  - 10000 - 12000
  - 8000 - 10000

**Table:**

<table>
<thead>
<tr>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Neither</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
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<tr>
<td>0 0%</td>
<td>16</td>
<td>9</td>
<td>19</td>
<td>1 25%</td>
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<tr>
<td>27%</td>
<td>15%</td>
<td>32%</td>
<td>25%</td>
<td></td>
</tr>
</tbody>
</table>
Consumer Confidence, Spending & Credit

Consumers Contracting dramatically

Source: economy.com
Inflation Trends

Inflation not major concern

Core CPI

Decline due to Apparel & Auto Reductions

Producer Prices

Source: economy.com
Interest Rates, Mortgage Rates & Spreads

Fed Funds Rate

Mortgage Rates

Mortgage Spreads

Source: economy.com
Housing Activity and Delinquency Rates

In 6 mo, housing crisis behind us

Construction

New residential construction, mil, SAAR

Delinquency & Default

Year-over-year difference in first mortgage, % of dollar volume, basis points

Housing Index

Present sales
Future sales
Buyer traffic

Source: economy.com

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The American Dream or ...
Government Intervention: Credit & Housing

• Troubled Asset Relief Program (TARP)
  – Objectives
    • Stabilize financial institutions & provide liquidity
    • Restore business and consumer confidence
  – $700 billion Bailout (?) Budget
    • $250 b to take equity-like positions in financial institutions
    • Purchase commercial paper

• FDIC
  – Insurance $250,000 for interest deposits
  – Unlimited for non-interest deposits (i.e., business working capital)

• Federal Housing Finance Agency (FHFA)
  – Placed Fannie Mae & Freddie Mac in conservatorship
  – Spending $200 b buying troubled mortgages,
  – Encouraging workouts to reduce foreclosures
Economic Environment: Snapshot

Macroeconomic Environment

- Economy in recession; painful and long
- Businesses struggling, stocks volatile
- Consumers bearish
Part II: Capital Markets & Submerging Trends

The Perfect Storm
- Credit
- Confidence
- Consumers

Institutional Capital Flows

Source: 2008 Emerging Trends
Valuation: Spatial Balance, Capital Surplus

**Property Level**
- Direct Ownership
  - Property-level
    - Most important

**Spatial Balance**
- Cap Rates
  - Property-level
    - Less important

**Entity Level**
- Partnerships
  - Funds
    - Syndications
  - REITs
  - CMBS
  - REOCs
  - Synthetics, TICs

**Capital Surplus**
- SWAPs, Derivatives
  - Synthetics, TICs

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Commercial Leverage Issues

- Leverage Issues; Project Risk
  - DCRs: lowered; escrow subsidized; eased via bullets: 3, 5, 10 yrs
  - LVs
    - Record values/low Cap Rates;
    - Some 100% financing; financial engineering, mezzanine debt

- Leverage Spread: Borrower Risk
  - Easy credit & relaxed underwriting standards
  - Non-recourse debt
  - Unqualified or unregulated Investors: (TICs)

- Outlook for Commercial Debt
  - Limited supply; flight to quality
  - Tighter; increased equity requirements and recourse
Institutional Cap Rates: Today & Tomorrow

**Cap Rates Today**

- 5% or less
- 6%
- 6.5%
- 7%
- 7.5%
- 8%
- 8.5%
- 9%
- 10% or more

**Cap Rates in 2 Yrs**

- 5% or less
- 6%
- 6.5%
- 7%
- 7.5%
- 8%
- 8.5%
- 9%
- 10% or more

**Findings**

- Cap Rates too low
- Cap Rates up for 2+ years
- Lenders too risk-average
- Investors can’t price risk

NCREIF Cap Rates 4 quarter moving average

CPTA.png

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Institutional Capital Flows & Outlook

• Decreased capital flows
  – Rising Return/Yield hurdle
  – Allocation down via denominator effect

• Investment Preferences
  – Search for value/yield; eschew risk
  – Fewer products/structures

• Timing
  – Patient; waiting for bottom
  – Indecisive; slower to act

• Opportunities
  – Cash is king; Big and Quick
  – Channel sourcing; REO, TICs
  – Asset takeovers
  – Promoted interests
  – Portfolio Acquisitions
Capital/Spatial Divide: Commoditization

Market Risk/Return Long-Term

Commoditized Pricing Behind Us

- Challenges
  - 2\textsuperscript{nd} and 3\textsuperscript{rd} Tier Markets
  - Weak Product: location, design, tenancy

- Opportunities
  - Market Targeting/Timing
  - Market Fundamentals; specialized skills & expertise

Recent: 5 yrs

Commoditized Pricing Behind Us

- 5 yrs

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Local Market Challenges

Market Challenges
• Financial Service-Dominated
• Secondary and Tertiary Markets

Fundamental Opportunities
• High Growth
• High Barriers to Entry

Diversification Opportunities
• Strategic Diversification
• Portfolio Acquisitions & SWAT Team Mobilized

Financial services ex real estate, % of employment
U.S.=4.5%

DPC Classification
- Dynamic
- Strong
- Cyclical
- Moderate
- Static
Real Estate Capital Markets Overview

- Construction Activity
- Private Equity Market
- Public Equity Market
- Commercial Mortgage Market
- Foreign Investment

- Significant Contraction
- Demand off, wait & see
- Tightening, discipline
- Red light; down, down
- Still attracted by cheap $, but more deliberate
Economic Environment vs. Real Estate Capital Market

**Macro-economic Environment**
- Economy tottering with risk of recession
- Businesses struggling, stock market volatile
- Consumers bearish

**Real Estate Capital Market**
- Wavering, delayed investor demand
- Rising Cap rates on private side
- Challenge accessing equity and recourse debt
Part III: Real Estate Market Fundamentals

Construction Activity

Vacancy Rates

Source: 2008 Emerging Trends
Office Real Estate

• Overview
  – Corporations will be giving back space
  – Sublease activity will increase
  – Vacancy rates will rise
  – Rents will soften
  – Credit will be tight
  – Construction will decline

• Areas of Concern
  – Speculative projects
  – Commodity product
  – Capital Needs: Cap X, TI’s
  – Second and third tier markets
  – Emerging sub-markets

• Opportunities
  – Projects
    • Abandoned Projects
    • Entitled Projects
    • Capital Needs Projects
    • Asset Takeovers
  – Sourcing
    • Institutional REO
    • Corporate REO
    • Marginal Owner Refin
Retail Real Estate

• Overview
  – Retail Sales will be tepid
  – Inventories will be lean
  – Credit tight, local and regional players
  – Retailer contraction; unit profitability
  – Defensive capital to protect markets

• Areas of Concern
  – New unproven & unopened stores
  – Underperforming existing units
  – Unanchored Life-style centers
  – Tenant Bankruptcy
  – Mixed-use in marginal markets
  – TOD Oversaturation
  – Underparked MU

• Opportunities
  – Projects
    • Lost Anchors
    • Entitled/Spec Projects
    • Capital Needs Projects
    • Asset Takeovers
  – Sourcing
    • Undercapitalized owners
    • Institutional REO
    • Corporate REO
    • Tenant-owned Pads
Industrial Real Estate

- Overview
  - Absorption slowing
  - Rents softening
  - Construction moderating
  - Logistics Models
  - Supply Chain/Technology
  - Globalization

- Areas of Concern
  - Overbuilt markets
  - Functionally obsolescence
  - Office Showroom/Flex
  - R&D facilities

- Opportunities
  - Projects
    - Lost Tenants
    - Functional Obsolescence
    - Capital Needs Projects
    - Changing H&B Use
  - Sourcing
    - Undercapitalized local owners
    - Institutional REO
    - Corporate REO
    - Asset Takeovers
Multifamily Real Estate

• Overview
  – Modal Shift: Rent vs. Own
  – Demographic/Diversity
  – Absorption rising
  – Vacancy rates firming up
  – Rents rising

• Areas of Concern
  – Homogenized Product
  – Product Positioning
  – Re-apartmenting
  – Density as an End vs. Means
  – Parking: Shared

• Opportunities
  – Projects
    • In development
    • Entitled
    • Repositioning
    • Conversion (future)
  – Sourcing
    • Undercapitalized local owners
    • Institutional REO
    • Corporate REO
    • Asset Takeovers
Economy vs. Capital Market vs. Spatial Market

Macro-economic Environment
- Economy tottering with risk of recession
- Businesses struggling, stock market volatile
- Consumers bearish

Real Estate Capital Market
- Wavering, delayed investor demand
- Rising Cap rates on private side
- Challenge accessing equity and recourse debt

Spatial Market
- Fundamentals continue to weaken mirroring economy
- Vacancy rates rising, rents softening
- Stagnating demand, tempered recovery
Contemporary Portfolios: Capital/Spatial Convergence

Client Goals & Objectives:
Portfolio Strategy

Main Street

Wall Street

Aggregate First Generation Portfolio

Open-end Fund 1
Open-end Fund 2
Closed End Fund 1
Closed End Fund 2
Specialty Fund

Core

Non-Core
International
Commercial Mortgages
REITs
Securitized Products/

Aggregate Second Generation Portfolio

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Will Government Intervention Work?

- **No**
  - Not enough $; too little, too late
  - Not address mortgage issue
  - Ill-conceived; gov only stupid buyer
  - Cycle inevitable, let it play out
  - Not deal with fundamental issues
  - Not deal with commercial bomb
- **Not right away**
  - Not until credit crisis resolved
  - Curtail negative, but take time
  - Not a quick fix; eventually
- **Limited**
  - Marginal help
  - Too long, slow, costly

- **Mixed/Maybe**
  - Ok for banks, not taxpayers/econ
  - Essential to avoid further erosion
  - Create illusion of stability
  - They don’t know what they’ll do
- **Yes, but only if...**
  - Buy truly toxic loans
  - Have Stopgaps to avoid foreclosure
  - Banks forced to loan vs. hoard
- **Yes**
  - Restore Confidence; banks/market
  - Fear removed, mitigated
  - Put a floor on bottom
  - Add essential liquidity
  - Get wheels in motion

**Yes; 50% of votes**
What More Should Government Do?

- No more actions
  - Don’t know
  - Nothing
  - Enough already; Out of tricks

- Taxes
  - Cut capital gains taxes
  - Cut income & capital gains
  - Create incentives

- Mortgages
  - Lower rates
  - National loan program

- Market-based solutions
  - Stimulus package
  - Eliminate mark to market accounts

- Equity infusion
  - Inject equity; take positions
  - Pari pasu with private investors
  - Force liquidity; flow-through

- Psychic Interventions
  - Leadership stability (Paulson)
  - Restore accountability
  - Remove “entitlement”

- Regulation
  - Increase Oversight
  - Proactive regulations

- Other:
  - Global action/world leader
  - Create RTC-like entity
  - Education
Greatest Risks to Commercial RE?

- **Equity**
  - Decline in qualified buyers
  - Capital shortage near-term
  - Players on sidelines

- **Debt Access**
  - Tightened credit
  - Credit hangover
  - General shortages
  - Deleveraging effects
  - Illiquidity

- **Debt Rollover**
  - Maturing bullets
  - Mezzanine
  - Default increases
  - Non-recourse walk-always

- **Demand**
  - Employment losses
  - Tenant Bankruptcies
  - Consumers and confidence

- **Fundamentals**
  - Overall deterioration
  - Erosion in market balance
  - Rising vacancies, rents declines
  - Rising costs

- **Re-pricing/Valuation**
  - Some already occurred
  - Further valuations slippage
  - Foreclosures
  - Non-recourse walk-always
Greatest Opportunities?

- Get in the game
  - Be a player
  - Be Opportunistic
- Cash
  - At bottom
  - Cash is king
  - Deleverage
- Debt
  - Distressed
  - Discounted
- Distressed
  - Properties
  - Sellers; overleveraged
  - REO
  - Any form

- Markets
  - Secondary and Tertiary
  - Lower Cost
- Property Types
  - Land
  - Apartments, student, assisted
  - Industrial/flex
  - Medical
- Value creation
  - Repositioning assets
  - Adding management expertise
  - Takeovers
  - Re-tenanting
  - Provide liquidity, capital
Key Topics of Interest?

• What’s happening?
• Where are we headed?
• Where’s the money?
• Who steps in?
• What role securitization?
• What about sustainability?
• Demand/demographics?

• What to do?
  – Opportunities
  – Survival
• When to do it?
• Where to do it?
• How to do it?
• Lessons Learned?
Summary

• Introduction

  – Part I: Macroeconomic Conditions
  – Part II: Capital Markets
  – Part III: Real Estate Fundamentals

• Challenges, Issues and Opportunities

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  (206) 616-2090