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COVER STORY

The Road to Recovery

The bumpy ride continues but cash-rich investors may detour into bargain territory.

By Kenneth P. Riggs Jr., CCIM, CRE, MAI

At this juncture, it is clear that some commercial real estate investors are farther down the road to recovery than others. Institutional investors are up against the same roadblocks affecting regional property investors, but the large institutions already have worked through a lion's share of re-pricing issues. This is due to the regulatory requirement of mark-to-market accounting and pressure from institutional boards to get their portfolios valued at market.

Unfortunately, the same cannot be said for the broader commercial real estate market. As a whole, property investors have not embraced the market's harsh realities, so 2010 will be a year of reckoning for many investors who up to now have been able to defer their issues to a later date. Those playing the "blend, extend, and pretend" game may be forced to look ahead and see how long, bumpy, and daunting the road to recovery really is.

Two Roadblocks

We are edging out of one of the worst economic climates since the Great Depression, according to some historians. Although the recession may be over and we have avoided a total collapse of the financial system, we are still grappling to find stable footing and direction.

Commercial real estate continues to suffer on two fronts: space demand — fewer workers and fewer customers mean businesses need less space — and upside-down credit — loans are coming due at a time when property values often are less than the amount owed on them.

Unfortunately job recovery may be several years away. In fact, most economists expect job loss to continue increasing until early to mid-2010, after which the unemployment rate likely will remain flat and begin to improve at a very slow pace. Ultimately, job growth won't improve until consumers feel more confident. Although government-sponsored incentives like the Cash for Clunkers program rev the economic engine in sporadic bursts, consumers need to start spending consistently on items beyond basic necessities to keep the economy moving.

Until businesses start hiring again and more space is needed for added workers or equipment, commercial real estate vacancy rates will continue to increase, sale prices will remain low or possibly decline further, and rental rates will remain flat or drop even more.

The 2010 outlook for the credit markets isn't much better than what we experienced in 2009. Many commercial mortgage-backed securities and whole loans are coming due in the next couple of years, resulting in delinquencies, restructuring, and/or foreclosures on many of those properties. Also at risk are commercial banks, holders of about half of the \$3.4 trillion in outstanding commercial real estate debt. More than a hundred banks failed in 2009, nearly depleting the Federal Deposit Insurance Corp.'s insurance fund. And hundreds more problem banks are expected to fail this year, according to the FDIC.

Reality is setting in, and the economic recession we thought we had in early 2008 has turned out to be much deeper and longer and has inflicted much more damage to the commercial real estate industry

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CCIM's 2010 Legislative Analysis

Two issues top the federal legislative agenda for the commercial real estate industry.

Energy. Although energy and climate change legislation took a backseat to healthcare debates in late 2009, Congress will focus again this year on passing legislation to reduce greenhouse gas emissions.

In June 2009, the U.S. House of Representatives passed H.R. 2454, the American Clean Energy and Security Act. The original draft would have required energy audits and labels for all buildings and mandated energy rating labels to be disclosed in property lease and sales documents. CCIM Institute lobbied against these provisions and instead asked Congress to support positive incentives for retrofitting buildings with energy efficient improvements, such as those included in H.R. 1778 by Rep. Peter Welch (D-Vt.). This proposal was later approved as an amendment to H.R. 2454.

Additionally, the approved House bill does not require audits, limits labeling to new construction only, and prohibits the Environmental Protection Agency from regulating commercial buildings under the Clean Air Act. Overall, the real estate provisions in the version passed were much more favorable to the commercial real estate industry.

In September 2009, the Senate introduced a similar climate bill, calling for a 20 percent cut in greenhouse gas emissions from 2005 levels by 2020. If the Senate passes its own version of an energy and climate bill, a House-Senate conference committee will be held to reconcile differences between the two bills. CCIM Institute and the National Association of Realtors will continue to work with Congress to ensure that the provisions remain favorable to the commercial real estate industry.

Taxes. Falling tax revenues and increased government spending due to the economic crisis have put lawmakers under pressure to seek new revenue sources. In addition, House Ways and Means Committee Chairman Charlie Rangel (D-N.Y.) has indicated that "everything is on the table" as part of his plan to restructure the current tax code. This could mean allowing the

than anyone expected. This is another year when many investors will hunker down, face gut-wrenching issues, and make some difficult decisions. But 2010 also may be a good year for investors to purchase quality properties at reduced prices. In Real Estate Research Corp.'s fall 2009 investment survey, institutional respondents issued a strong buy rating. (See "It's Time to Buy.")

In this commercial real estate market only the strong — investors with the courage, conviction, and most importantly, cash — will persevere and prosper. The game is on, the time is now, and the industry learns once again that commercial real estate is a cyclical business as we continue traveling the long road to recovery.

Sector Trends Weak

RERC expects 2010 to be a year of increasing highs and lows for the broad commercial real estate market: higher vacancy rates, higher loan delinquencies, and higher transaction volume versus lower sale prices, lower investment expectations, and lower rents.

According to RERC's adjusted quarterly analysis, commercial property transaction volume peaked in 2Q07 and appears to have bottomed out in 1Q09. This peak-to-trough transaction volume change was nearly 90 percent. So far, since 2Q09, the overall transaction volume has been steadily increasing as more opportunities for distressed properties become available. While general buying trends are just beginning to gain strength, investors have indicated favorites among the property types.

Multifamily. While it cannot compare to the glamour of a rising stock market, it is no surprise that a safe, solid investment like apartments earned the highest investment conditions rating among the property types. RERC's institutional investment survey respondents rated multifamily 5.6 on a scale of 1 to 10, the highest-rated property sector during the past year. This rating is not too far off from its all-time average (since 1991) of 6.3. Although multifamily is expected to recover first when the economy starts to grow and job growth strengthens, vacancy is still increasing. The National Association of Realtors expects this sector's vacancy rate to peak at 7.9 percent in 4Q09 and occupancy growth to turn positive. It will continue to increase slightly during the first half of 2010.

The 12-month trailing size-weighted average price per apartment unit declined to approximately \$76,000 in 3Q09 or about 25 percent less than the price a year ago, according to the RERC/CCIM Investment Trends Quarterly. RERC's adjusted quarterly transaction volume for the apartment market peaked during 4Q06 and seems to have touched bottom during 1Q09, about when the sector's adjusted quarterly price per unit started to stabilize. Since the peak in volume, there has been an approximate 90 percent decline in transaction activity.

At 7.5 percent, the apartment sector continues to have the lowest required going-in institutional capitalization rate on a national level among the various property types. The U.S. West region has the lowest apartment cap rate among the regions, and the South region has the highest apartment cap rate. The South region also has the lowest price per apartment unit.

Office. Under pressure throughout 2009, the office sector will see no relief in 2010. Interestingly in 3Q09, RERC's institutional survey respondents gave the central business district an investment conditions rating of 4.6 on a scale of 1 to 10. This is the second-highest rating among the 10 property types RERC covers on a regular basis but well below the overall CBD office average (since 1991) of 5.5. (See "Investment Ratings.") With unemployment expected to continue to increase in 2010, demand for office space should remain relatively low. According to CBRE Econometric Advisors, formerly known as Torto Wheaton Research, office vacancy is expected to increase to 18.5 percent by year-end 2010. The current office vacancy rate is 16.1 percent, the highest since 2Q04. CBRE-EA also expects office rents to continue falling throughout 2010 and possibly start to stabilize in 2011.

2001-03 Bush tax cuts to expire in 2011 or possibly repealing some of these tax cuts before their expiration date.

President Obama's pledge not to raise taxes on the middle class makes it likely that the Democratic-controlled Congress will discuss increasing the top two income rates or allowing them to expire in 2011. If these top rates increase, less money will be available for high-income earners to invest in commercial real estate, putting more pressure on the industry.

Also in light of the economic crisis, President Obama has stated that the capital gains rate will remain unchanged during 2010. Unless Congress acts, however, the current 15 percent rate will revert back to 20 percent on January 1, 2011. Eliminating the current capital gains treatment for any carried interest of a real estate partnership also will likely be a consideration.

Any tax increase related to real estate clearly discriminates against it as compared to other assets and puts it at a greater competitive disadvantage for investment dollars. Additionally, it puts more pressure on a fragile commercial real estate industry. Whatever direction Congress and the president take, CCIM Institute will continue to fight for tax policy that would encourage investment in the commercial real estate industry.

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Unfortunately, office prices' next headwind will be deteriorating market fundamentals. RERC's ITQ analysis shows that the average price per square foot of office space declined by about 25 percent during the past year to an average price of \$181 psf in 3Q09. While the 12-month trailing prices fell, quarterly prices had started to stabilize in 2Q09 after adjusting to cap rate increases. Unfortunately, the price psf of office space is expected to decline in 2010 and faces more uncertainty in 2011. The office market's quarterly transaction volume peaked in 1Q07 and found bottom in 2Q09, a decrease of more than 90 percent.

| 2010's Top 10 | |
|---|---|
| Using variables such as gross domestic product by metropolitan area, unemployment, housing data, per capita income, and commercial real estate fundamentals and transaction data, we've compiled 10 markets that are expected to perform well in 2010. These top commercial real estate markets were chosen from the 48 metros that are reported on in RERC/CCIM Investment Trends Quarterly. | |
| TOP METROS | KEY CONDITIONS |
| Austin, Texas Denver Honolulu Houston Oklahoma City Pittsburgh Salt Lake City San Antonio Seattle Washington, D.C. | <ul style="list-style-type: none"> Housing markets have shown little depreciation (and in a few markets, there is positive appreciation happening) as compared to the significant downturns in other markets. This helps keep consumer spending higher in these areas. Unemployment rates have remained relatively low, which in some areas is due to government and educational institutions, the presence of oil and energy industries, or new government stimulus projects. Commercial real estate prices, vacancy rates, and capitalization rates have remained relatively stable as compared to the other major metros. |

RERC's required going-in cap rate for the office sector for the year to come has remained flat for the past few quarters and stands at an average of 8.4 percent for institutional properties on an unleveraged basis. (See "Required Return Expectations.") Class A office properties in the East and West regions generally are seeing lower cap rates than this average. The size-weighted average price psf of office property in the East and West regions is approximately 45 percent higher than office properties in the South and Midwest regions.

Industrial. RERC's institutional investment survey respondents gave the warehouse sector a 4.6 investment conditions rating during 3Q09, effectively tying with the CBD office sector for second-highest rating. However, 4.6 does not even reach the midpoint of the rating scale and is well below the average 6.2 rating for industrial warehouses. The inventory of goods was reduced in 2009, but with consumer confidence and spending relatively flat, there is little demand for mass production and shipping of goods to be stored in America's warehouses. What's more, the existing availability rate for the industrial sector is already higher than it was in 1989, when CBRE-EA began tracking it. The availability rate for industrial properties is expected to increase to 15.5 percent by the end of 2010, a new record for U.S. industrial space. Net absorption has been negative for the past seven quarters, and CBRE-EA forecasts industrial net absorption to remain negative throughout 2010. Rents are expected to continue to decline in 2010, according to the TW Warehouse Rent Index.

Second-quarter 2007 was the peak for quarterly transaction volume, which started inching upward in 1Q09. The average price of industrial property declined to \$60 psf in 3Q09, an approximate 15 percent decline from a year ago. RERC's adjusted quarterly price psf for the industrial market peaked in 2Q07 and has yet to find bottom. From 2Q07 to 3Q09, prices have decreased approximately 30

percent on a quarterly basis. The price psf of industrial property is expected to stabilize or slightly decline during the coming year. RERC's required weighted average going-in cap rate for the industrial sector has been stable during the past few quarters and is expected to remain around 8.4 percent for the year ahead. As one would expect, the East and West regions have the lowest cap rates for the industrial sector and the highest average prices psf.

Retail. Given the change in consumers' shopping habits in this recession, investment conditions for the retail sector vary. For the most part, local shopping areas where consumers pick up their nondiscretionary items will continue to do best in 2010, as reflected by RERC's institutional investment conditions rating for neighborhood/community retail properties at 4.4. Compare this to the reduced amount of business typically seen by retail power centers during recessions and periods of high unemployment and one understands why the investment conditions rating for power centers is 3.2, the second-lowest rated sector among all the property types RERC regularly covers. Although very low, this rating is an improvement from 1Q09 when the investment conditions rating for retail power centers dropped to 2.6, the lowest rating ever received for this property type. Like the industrial sector, the retail sector's current availability rate of 12.2 percent already has surpassed the highest vacancy rate recorded since CBRE-EA began tracking these rates in 1991. By year-end 2010, expectations are for retail availability to be at 12.9 percent. Net absorption for the retail market has been negative for the past five quarters, according to CBRE-EA, and is forecasted to remain negative through the first half of 2010.

| Investment Ratings, 3Q09 | | | | |
|--|------|------|------|------|
| Rated on a scale from 1 (poor) to 10 (excellent) | | | | |
| SECTOR | 3Q09 | 2Q09 | 3Q08 | 3Q07 |
| Hotel | 2.6 | 2.1 | 3.9 | 5.4 |
| Industrial/Warehouse | 4.6 | 4.5 | 5.1 | 5.7 |
| Multifamily | 5.6 | 5.6 | 5.9 | 5.5 |
| Office/CBD | 4.6 | 4.4 | 4.9 | 5.9 |
| Office/Suburban | 3.8 | 3.7 | 3.8 | 5.5 |
| Retail/Neighborhood | 4.4 | 4.5 | 4.1 | 5.1 |
| Retail/Power center | 3.2 | 3.2 | 3.1 | 4.9 |
| Source: RERC Investment Survey | | | | |

The average price psf of retail space declined approximately 20 percent in the past year, with this sector priced at \$130 psf in 3Q09, according to ITQ transaction analysis. The quarterly retail price psf peaked in 2Q07 and began stabilizing in 2Q09. Watch for the price psf to come under pressure in 2010. Although the retail sector's quarterly transaction volume increased slightly in 3Q09, it is still down 75 percent from its 2007 high. RERC's required going-in cap rate expectation for the retail sector for 2010 has increased to 8.6 percent. On a regional basis, the lowest cap rates for this sector are in the East and West regions, where we generally are finding the highest prices psf as well.

Hospitality. The lodging market continues to suffer from both reduced business travel and leisure travel, and as a result, the hotel sector continues to receive the lowest investment conditions rating, 2.6, from RERC's institutional survey respondents. However, this rating was an increase from the previous quarter's rating of 2.1, which was this sector's lowest since 1992. Although returns can change quickly in this sector and the pace of decline has been slowing, expect the decline to continue in 2010, particularly in the luxury hotel segment, according to Smith Travel Research. Watch for occupancy to drop to 55.1 percent, average daily rate to decline 3.4 percent to \$93.16 per room, and revenue per available room to fall 4.0 percent to \$51.29. Although these forecasts are not positive, STR expects 2010 to be slightly better than 2009.

RERC's adjusted quarterly transaction volume shows that hotel volume peaked in 4Q07 and started to stabilize at the beginning of 2009. The average price per hotel unit has declined substantially

during the past year, and though there have been significantly fewer transactions to analyze, it appears that the strongest pricing averages can be found in the West region, while the lowest are in the Midwest. The quarterly price per unit for the hotel sector also peaked during 4Q07, but has yet to find a pricing bottom. With respect to cap rates, RERC’s required going-in institutional cap rate is 9.7 percent for the year ahead.

| Required Return Expectations, 3Q09 | | | | | | |
|--|---------------|-------------------|---------------|--------------------|--------------|------------------------|
| Weighted averages based upon 3Q09 NCREIF portfolio market values | | | | | | |
| Return (%) | Office | Industrial | Retail | Multifamily | Hotel | Overall average |
| Pretax yield/IRR | 9.7 | 10.0 | 9.7 | 8.9 | 11.8 | 10.0 |
| Going-in cap rate | 8.4 | 8.4 | 8.6 | 7.5 | 9.7 | 8.5 |
| Terminal cap rate | 8.6 | 8.7 | 8.6 | 7.6 | 9.9 | 8.7 |
| Rental growth | 0.8 | 1.1 | 0.8 | 1.2 | -0.4 | 0.9 |
| Expense growth | 2.6 | 2.7 | 2.9 | 2.7 | 2.8 | 2.8 |
| Source: RERC Investment Survey | | | | | | |

Staying on the Path

Commercial real estate lags the economy, and since the economy is just starting to find a bottom, we still have a slow recovery path ahead for 2010 and 2011. Commercial real estate prices have come down significantly during the past 18 months and will continue to decline throughout 2010. Debt capital will continue to be stingy, and the industry will continue to deleverage. Investors will grapple with less pricing power and lower demand for space.

This is all part of an investment class running through its down cycle. Though we told ourselves in the 1990s that we would not make the same mistakes again, our memories are poor. As prices edged up more than 60 percent between 2003 and 2008 for many properties in most locations, we told ourselves that it was different this time. (More likely greed caused our memories to fade.)

Warren Buffet, one of the foremost investors of our time, tells us, “Be fearful when others are greedy, and be greedy when others are fearful.” As re-pricing takes hold, equity capital is eyeing solid investment opportunities. We do not have the liquidity problem of the 1990s when sellers could not find buyers at any price. Today we have a pricing versus value quandary — plus a confidence issue. However, most investors are weighted heavily by their existing investments and do not have dry powder to get new deals done, even if they have the courage to tackle new investment. The deals will be done with fresh capital from new investors and large institutions that have the depth and courage to access capital.

In the 1990s the noted real estate investor Sam Zell said, “Stay alive to ‘95.” This time around, at a recent conference where both Zell and I were speaking, he said, “Come clean by 2013.” While it’s not a clever rhyme, let’s just say: Survive 2010! Further, be happy that you did, hopefully still in one piece with some courage and dedication left to continue on into commercial real estate’s next investment cycle.

