

Will Commercial Real Estate Emerge from the Market Down-Turn? Your Frequently Asked Questions Answered March 2009

While commercial real estate has not been immune from the broader economic turmoil, we continue to have long-term confidence in the asset class. When you look past the shorter-term risks and pricing declines, the fundamentals of commercial real estate are stronger than you might think, and for companies with a strong balance sheet, low leverage and access to cash, the buying opportunities are tremendous. Long term, demand will be driven by the fact that the U.S. population grows by 2.7 million people a year in net births over deaths plus immigration. These people will always need a place to work, eat, sleep, shop and play — and real estate will continue to fill that demand.



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Are the many negative headlines in the papers or on TV correctly portraying the current state of the commercial real estate market?

Most of the news is about the housing (home ownership) market which has nothing to do with commercial real estate. Sub-prime home loans have a default rate of about 20%, prime home loans have a default rate of about 6%, but commercial real estate loans have a default rate of only 1%. The media does not do a good job of distinguishing between residential homes and commercial real estate.

While there has been some negative coverage of the commercial real estate market, there are a number of factors to consider before simply assuming that there are no positives or opportunities to be found in the commercial real estate market. Our answers to the questions below provide a more in-depth perspective on why we continue to believe in the power of commercial real estate.

What signs or indicators might we look for to indicate a possible bottom and subsequent turn around for commercial real estate?

Employment growth is the key to demand for commercial real estate. Most economists predict employment growth will begin again in late 2009 or early 2010. Therefore we don't expect to see strong demand growth until mid-2010 at the earliest.

How does today's correction compare to past corrections? Are we seeing statistics indicating today's downturn could be or is already worse than past corrections?

The demand side of this correction looks like the early 1980's down cycle and could drop down to be as low as the early 1970's down cycle. The supply side in this cycle is actually more moderate than most previous cycles as the amount of new supply in the pipeline today is much lower than the down cycles of the past 40 years. Occupancy declines have been very moderate to date and rental declines have also been moderate. Combining demand and supply, we expect occupancies to decline less than previous cycles and the rebound should be rather strong.

Are there particular property types/tenants in key markets across the country that could remain insulated from current market conditions?

All property types are affected by the economy, however those property types that produce basic necessity goods will fare the best. Grocery-anchored retail centers should fare well as people need to eat and will buy more groceries and eat out less. In 2008, grocery store sales were up 6% for the year. Office space is leased with long-term 10-year leases on average and companies still pay the rent even if the space is empty. They may put the space up for sub-lease, but they still pay the rent. Credit of the tenants is a key factor in underwriting office purchases.

What impact if any is there on the commercial real estate market if pension plans, endowments and sovereign funds are selling their assets in order to raise capital or re-balance their overall portfolios?

Institutional investors have had a problem because their stock portfolios dropped so much that their allocation to real estate now appears to be too high — even though the dollar amount is the same. Some institutional investors have tried to sell commercial real estate assets, but are not getting the prices they want. They are not distressed sellers, however, and are not forced to drop their prices. Because they have a long-term investment horizon, they can opt to hold the commercial real estate until market prices improve. Their long-term view should keep them from dumping properties just to raise cash when they have liquid assets in so many other categories.

What are the key financials to know in order to evaluate and discern the strength of a portfolio? Are these metrics the same for traded vs. non-traded real estate investment trusts (REITs)?

Real estate, no matter how it is owned, has the same basics. The income stream comes from the tenants and their leases. Credit tenants and long-standing leases are the key to good long-term income from the building. The quality of the building and the management are important to keeping operating costs low and allowing more money to reach net operating income (NOI). Next, the mortgage debt on the building should be a low interest rate so more money flows to the equity investors. Finally, the date that debt matures is a key component of potential liquidity. Debt is currently hard to find and maturing loans may create a liquidity problem. We assume that the market will stabilize in a few years — so debt maturities that are two or three years out are not as much a problem as current debt maturities.

How are the credit markets affecting the commercial real estate markets?

The lack of credit availability has slowed the commercial real estate market to less than one-fifth of its current high volume in 2007. Fewer deals are getting done, although commercial real estate prices have not dropped as low as many predicted because owners have enough cash flow to make their mortgage payments.

I've read that there is a massive amount of debt coming due in 2009 and 2010 that commercial real estate borrowers & REITs must contend with. How will this further impact the commercial real estate market?

Most commercial real estate buildings are cash flowing and able to make their mortgage payments — the default rate on commercial real estate debt was a low 1% at the beginning of 2009. However, most commercial real estate loans have five- to ten-year maturities and when the debt matures the owner/borrower must find a new loan. And new loans are very hard to find today. Thus, the commercial real estate industry doesn't typically have distressed properties, but distressed owners (both individual owners and REITs) who cannot find refinancing. This provides an opportunity for buyers with cash to purchase good properties at lower prices.

Explain the benefits and terms of a common type of lease between a landlord and tenant?

A lease is a legal contract between two people or businesses. It is the right to use space for a specific time period for a specific lease payment. Office leases usually run five to ten years. Industrial leases usually run three to seven years. Retail leases normally run three to five years (except for major anchor tenants like grocery stores where leases are normally 20 years). Apartment leases run for one year and hotel leases run for one night. Once the lease is signed and the tenant is occupying the space, the rents must be paid and will be paid unless the tenant goes bankrupt. These stable and predictable cash flows are what banks and investors use to underwrite commercial real estate investments.

A famous commercial real estate phrase is “location, location, location.” What does this mean?

Properties in good metropolitan markets that have long-term growth prospects do better than properties in bad markets. Properties in good sub-markets (a lot of people with good incomes and little room to build new buildings) will do better than bad submarkets. Properties on the better streets (the financial district for office or the major retail street for stores) will do better than properties on bad streets or in rundown neighborhoods.

Conclusion

The effects of the down market have been indiscriminate across industries, and as always, the market is cyclical. Since commercial real estate has usually followed the economy throughout its cycles, an economic recovery bodes well for commercial real estate investors who are patient. In the meantime, good locations, good tenants and a good capital structure are the keys to weathering the current down-cycle in commercial real estate.

The dislocation in the market has created opportunities to acquire core assets in attractive markets that haven't been available for years. Today, sellers are competing for those buyers who can make a cash purchase, opening up additional opportunity for those commercial real estate investors who have cash available to make purchases.

Commercial real estate is a separate asset class that has historically demonstrated stable income and price appreciation. Today, it continues to be widely regarded as a valuable component of an investment portfolio for investors of all types, offering the potential for stable current income, capital appreciation, low correlation to stocks and bonds, less volatility than the stock and bond markets and an inflation hedge.

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