

Commercial Real Estate in the Recession and Recovery

Your Frequently Asked Questions Answered

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Commercial real estate is following the broader economic downturn. As employment losses produce demand declines, occupancies and rents are falling to reflect those fundamentals. Commercial property prices have also fallen as mortgage financing has become much more difficult to obtain. Long term, demand should follow the economic recovery forecast for 2010. Coupled with ever increasing population growth means that people will need space to work and live in — so demand for real estate should continue in the long term.

Below you will find the answers to some of the latest frequently asked questions we are hearing, as well as updates to some of the questions we covered in February 2009.



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New Questions Answered

What are the biggest impacts of economic decline on real estate?

Declines in the economy have now cost six million jobs and pushed the unemployment rate above 8%. Lost jobs mean lower demand for commercial real estate and almost all markets (except Washington D.C.) have seen declining demand for space in all the income-producing property types including office, industrial, retail, apartments and hotel. We expect occupancy levels to drop until employment growth returns. Lower demand also means that landlords will be forced to drop their rents when leases come due, **but** long-term leases that are in-place will help to keep property revenues from declining too much.

Has the other shoe dropped, so to speak, in commercial real estate? What is the outlook in the immediate term of 2009 – 2010?

When we talk about the “shoe dropping” in residential home ownership, we mean the price dropping since homes do not have rental income. The prices of commercial real estate have dropped, but at a much more moderate rate than homes. In 2008 while home prices were down more than 20%, commercial property prices were down only about 10%. In 2009 prices have come down another 10% for commercial real estate, but the transaction volume has dropped by 85% from the 2007 peak volume. However, the default rates in commercial mortgages are still very low at only 2%. There are many owners who simply do not want to sell at lower prices since the cash flow from their property is sufficient enough to pay the mortgage — so why not hold on until prices recover? The other shoe **may** drop for some commercial real estate owners when their mortgage matures (most commercial mortgages are usually only five to ten years long) and when their mortgage matures **if** they cannot find a new lender. The new, lower market price of their property means they can only get a smaller loan than they had before. In addition, many lenders are requiring lower loan-to-value amounts in their mortgages — forcing a lower mortgage amount. This means the owner will have to come up with a large sum of cash equity to put into the property at the time they refinance. Many owners do not have this cash and thus we have a distressed **seller** not a distressed property. This provides a great opportunity for buyers with a lot of cash.

To what extent does having cash today benefit a company or REIT?

As shown in the previous question, lenders are now requiring 40% to 50% down payments versus the 20% to 25% down payment requirement only two years ago. A commercial buyer with cash is able to purchase a property with the required equity money down, appealing to sellers who want to be sure their sale will close.

There is a lot of news about the retail sector with bankruptcies leaving high vacancy rates. Are there differences between retail properties, and which types are most likely to see high vacancy rates?

Retailers who sell luxury goods and discretionary goods have been hurt by the economic downturn for a number of reasons:

- 1) People who lose jobs do not spend.
- 2) People who saw a drop in their stock portfolios feel less rich and have started to save more money instead of spend it.
- 3) People whose home values have declined are not able to refinance to access additional money to spend.

These retailers see much lower sales and start to close unprofitable stores. Regional malls and specialty power center retail are hurt the most by this economic trend. Consumers also lower their spending habits by eating out less and looking for better prices. This trend helps grocery stores as people buy more food to cook at home (grocery sales were up approximately 5% in 2008¹) and food suppliers like Royal Ahold had a recent 12% dividend increase as case in point.² Consumers also look for better prices, and discount stores like Wal-Mart have seen sales increases from the economic downturn.

What types of commercial real estate are a good buy right now?

Commercial real estate prices **have** dropped so commercial real estate properties are a much better buy than they were one or two years ago. Finding properties with good quality tenants and long-term leases is the key to “buying right.” Office properties typically have the longest leases and a well-leased office property would be a good buy today — as long as the tenants have a stable outlook. Industrial properties have longer-term leases and would be a good buy today — again if the tenants have stable outlooks. Retail that is grocery anchored or has basic goods retailers would be the next best buy, again if the tenants have stable outlooks. Apartment prices are still fairly high and many apartment buyers are waiting for prices to drop further and employment to improve so they can expect increasing occupancy. Hotels are the riskiest property type and I would not recommend buying them today with the uncertainty in business and leisure travel.

A lot of REITs have cut dividends. What indicators are there to know if a dividend cut is coming?

A few REITs dropped their dividends due to declining cash flow, but **most** REITs dropped their dividends to conserve cash and prepare for good buying opportunities that should come when prices bottom out (they need large cash equity amounts to get financing). Any REIT that does not have a large amount of cash (approximately a quarter to a third of their equity amount) I would expect to see either a dividend cut or a stock offering to raise cash in preparation for future buying. Public REITs have raised more than \$14 billion in stock offerings in 2009 so far and their stock prices have increased.

¹ Reuters Fundamentals, Reuters Pricing and PwC analysis.

² March 2, 2009, Royal Ahold press release, “Q4 / Full Year 2008 Earnings.”

What are “legacy assets” and how are they impacting REITs currently in the market?

Legacy assets are properties that have been purchased at high prices over the past few years. These properties have higher prices and lower income yields. These legacy assets do not have the price appreciation potential that a new purchase at today’s lower prices would have. This means that a REIT with legacy assets has lower appreciation potential in the future. Investors should prefer REITs that have cash to buy properties today or new REITs that raise capital and buy properties at today’s lower prices.

How can new REITs get started in the current lending environment?

New REITs will have to raise equity capital first to be able to put down the 40% to 50% equity necessary to purchase a property and obtain 50% to 60% loans on the property. Many people in the real estate industry believe that 2010 may be the best buying opportunity for commercial real estate that has occurred in the last 2 decades. Once the economy starts to grow and jobs are created, the demand for commercial real estate in all property types should move up and the limited new supply of the past five years will create good rent and price growth.

Updates to Previously Answered Questions

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. Economists now predict GDP growth in the third to fourth quarter of 2009 and employment growth to begin again in the second to third quarter of 2010. Therefore we don’t expect to see real estate demand growth until late 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 with the employment losses the United States is experiencing. The supply side in this 2008/2009 down-cycle is actually more moderate than most previous cycles as the amount of new supply in the pipeline today is much lower (at 1.5%) than the down-cycles of the past 40 years, which had annual supply growth of 3% to 8%. Occupancy and rental declines have been moderate to date in most markets — the worst hit markets have been New York and California, where rents had run up faster than other U.S. markets. We don’t expect a rebound until late 2010 at the earliest.

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 (because it has not declined as much). Some institutional investors have tried to sell commercial real estate assets, but are not getting the prices they want. These investors 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. We have seen pensions and endowments reduce their purchases of new properties in 2009, but **very few** have sold any properties.

What are the key financials to know in order to evaluate and discern the strength of a REIT 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 in 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 debt 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. So a REIT with a low percentage of debt, little or no debt maturing over the next two years and lots of cash to buy new properties is in the best financial condition today.

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

Very low commercial mortgage availability has dropped commercial real estate transactions to only 10% of the peak volume in 2007. The commercial real estate industry is working with the U.S. government to get mortgage loans flowing again with such programs as the Term Asset-Backed Securities Loan Facility (TALF) — which started with targeting triple-A rated credit card, small business, student and auto loans by trying to thaw the securities market backed by those assets — and has since been expanded to include commercial mortgage backed securities among other asset classes. These programs may not show results until 2010, however. Commercial banks are lending VERY conservatively at 50% loan-to-value and life insurance companies are lending to their best customers at 50% to 60% loan-to-value. This means that only buyers with a lot of cash will be able to close deals.

Conclusion

The recession is putting pressure on commercial real estate owners and operators just like most other businesses. However, space is something that every person and business needs for daily activities, so demand never goes away completely and an increasing population means future demand should be coming. Commercial real estate will follow the economic cycle in a similar fashion to previous cycles. This time the low amount of new supply in the mid 2000s and no new supply in 2009 may produce a surprise increase in occupancies and rents when the economic recovery is in full swing — which is estimated to happen in 2010. This reality may also push up real estate prices!

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, and low correlation to stocks and bonds. In addition, real estate has proven to be less volatile than the stock and bond markets and a good hedge against inflation.

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