
Commercial Real Estate: Distress & Opportunity

UCLA Anderson Economic Forecast Conference

June 16, 2009

Pricing data utilized herein consists of closing prices on May 29, 2009. On that date, the DJIA was at 8500, the RMZ was at 447, and the 10-Year Treasury note was priced to yield 3.46%.

1) Where *should* commercial real estate be *valued*?

- Lower than many people think

2) Where *will* it be *priced*?

- Even lower than that

3) Will there be opportunities?

- Enormous ones...equity will be king

Real estate has been clobbered by a powerful one-two punch

1) The “low return world” is done

- Cap rates have increased a lot
- 969 - not a new area code, it's the path for cap rates this decade

2) Fundamentals are falling apart

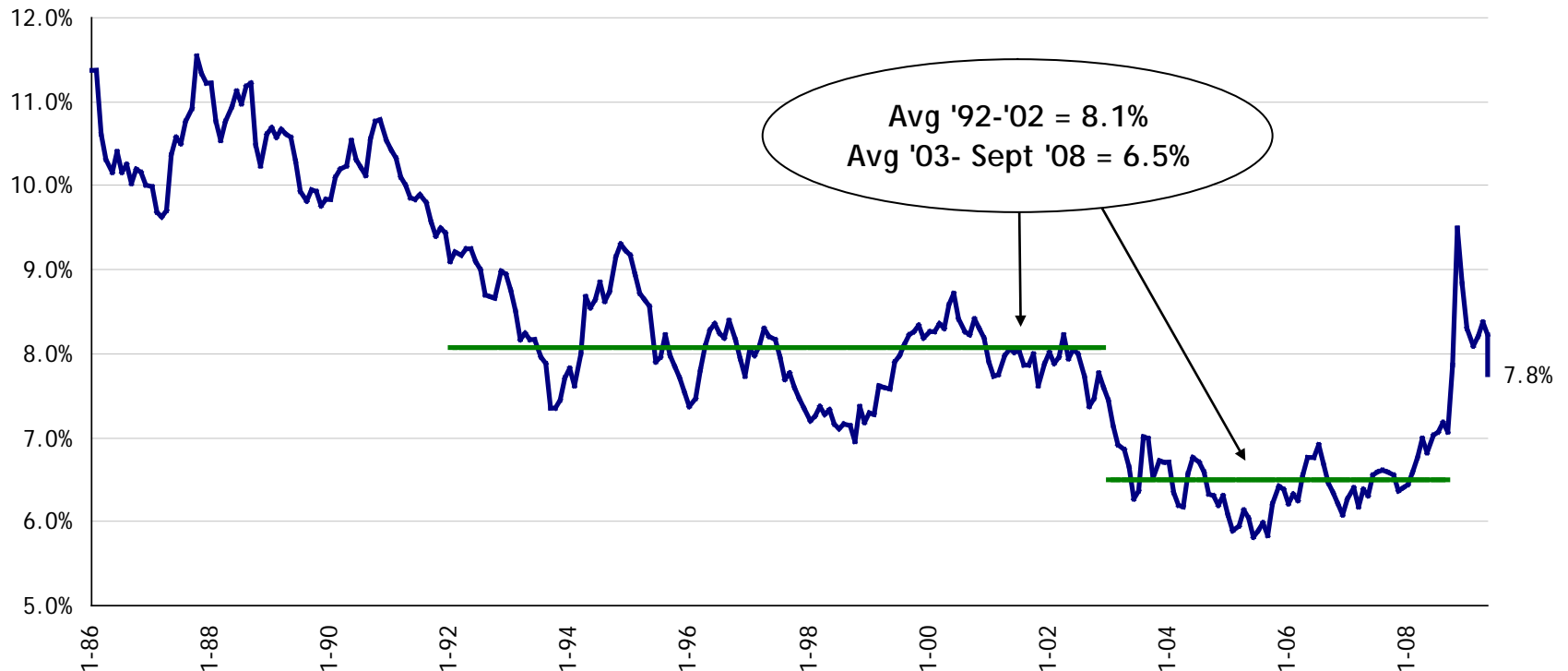
- Bubble underwriting called for huge growth
- Reality is that cash flow is declining
- Some sectors (e.g. retail) are in uncharted waters

We don't know where prices are for sure...nothing is trading...we *think* they're down 35-40%

Where Should Real Estate be Valued?

- ❑ **Punch #1: The end of the low return world - Baa corporate bond yields are much closer to the norms of '92-'02, as opposed to the bubble levels of '03-'07.**

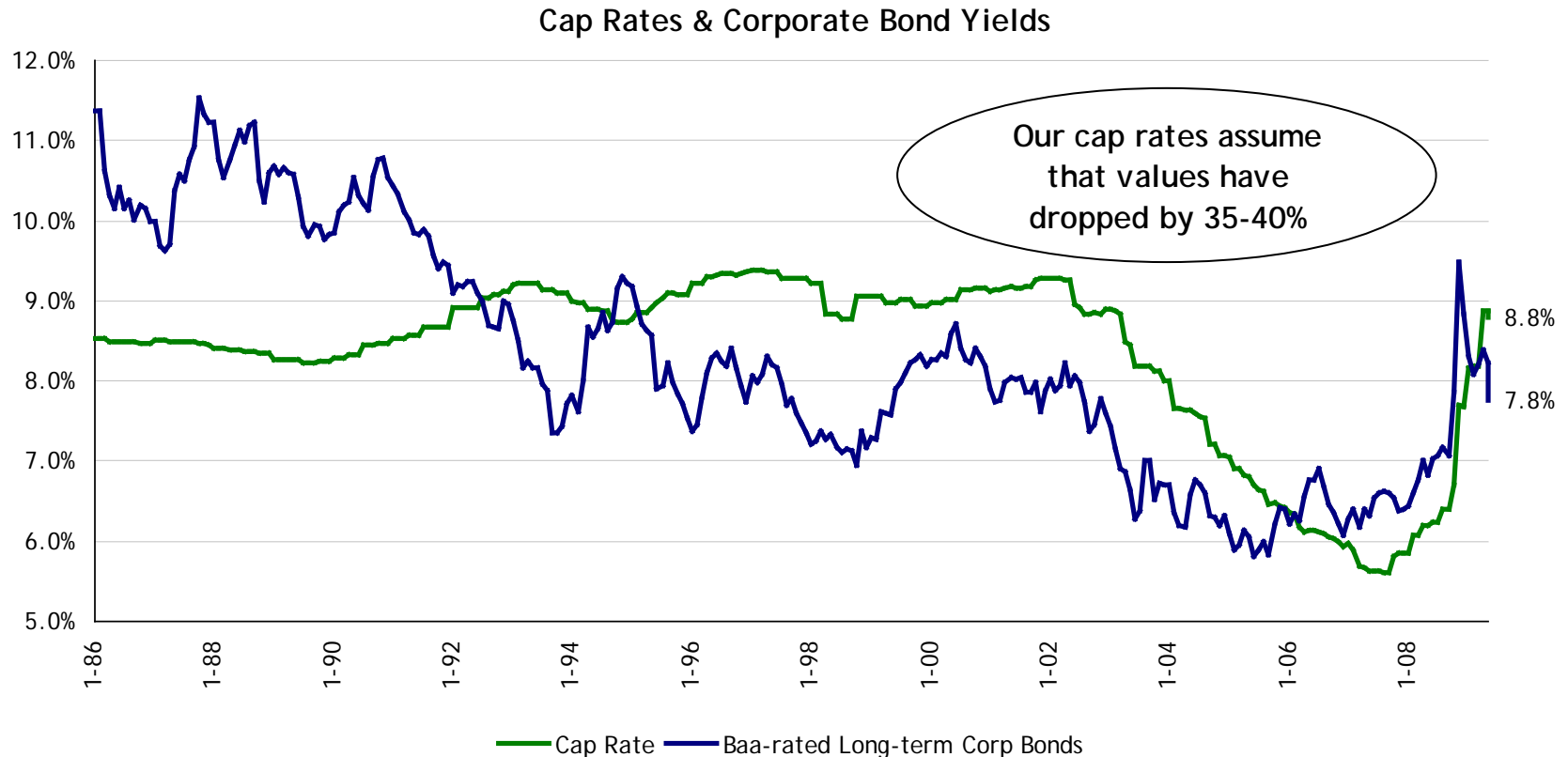
Baa-Rated Long-Term Corporate Bond Yields



Source: Moody's.

Where Should Real Estate be Valued?

- ❑ Rising bond yields result in higher cap rates. Though tough to peg amidst a dearth of transactions, cap rates are probably back to about 9%.

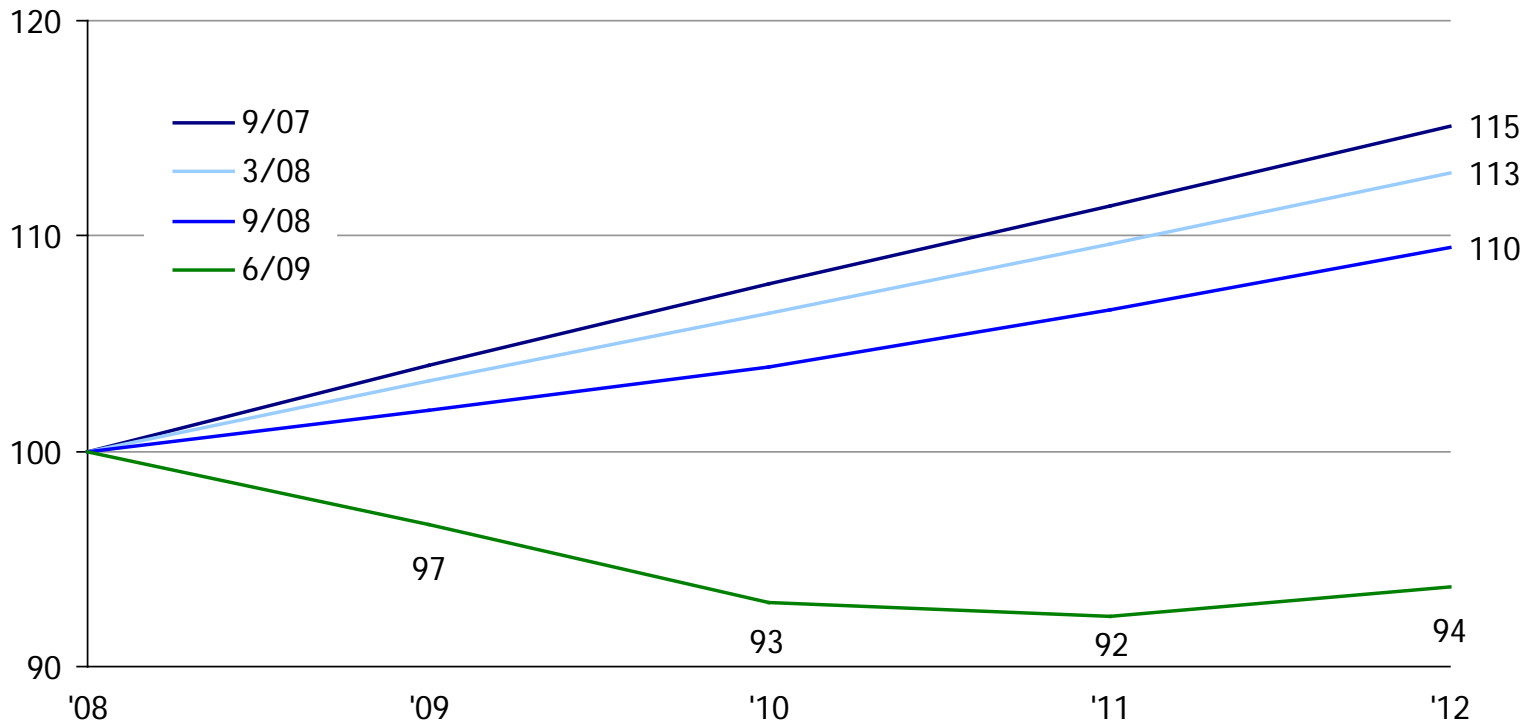


Cap rate is an average of the five major sectors: Apt, Industrial, Mall, Office, & Strip Center.
Source for corporate bond yields: Moody's.

Where Should Real Estate be Valued?

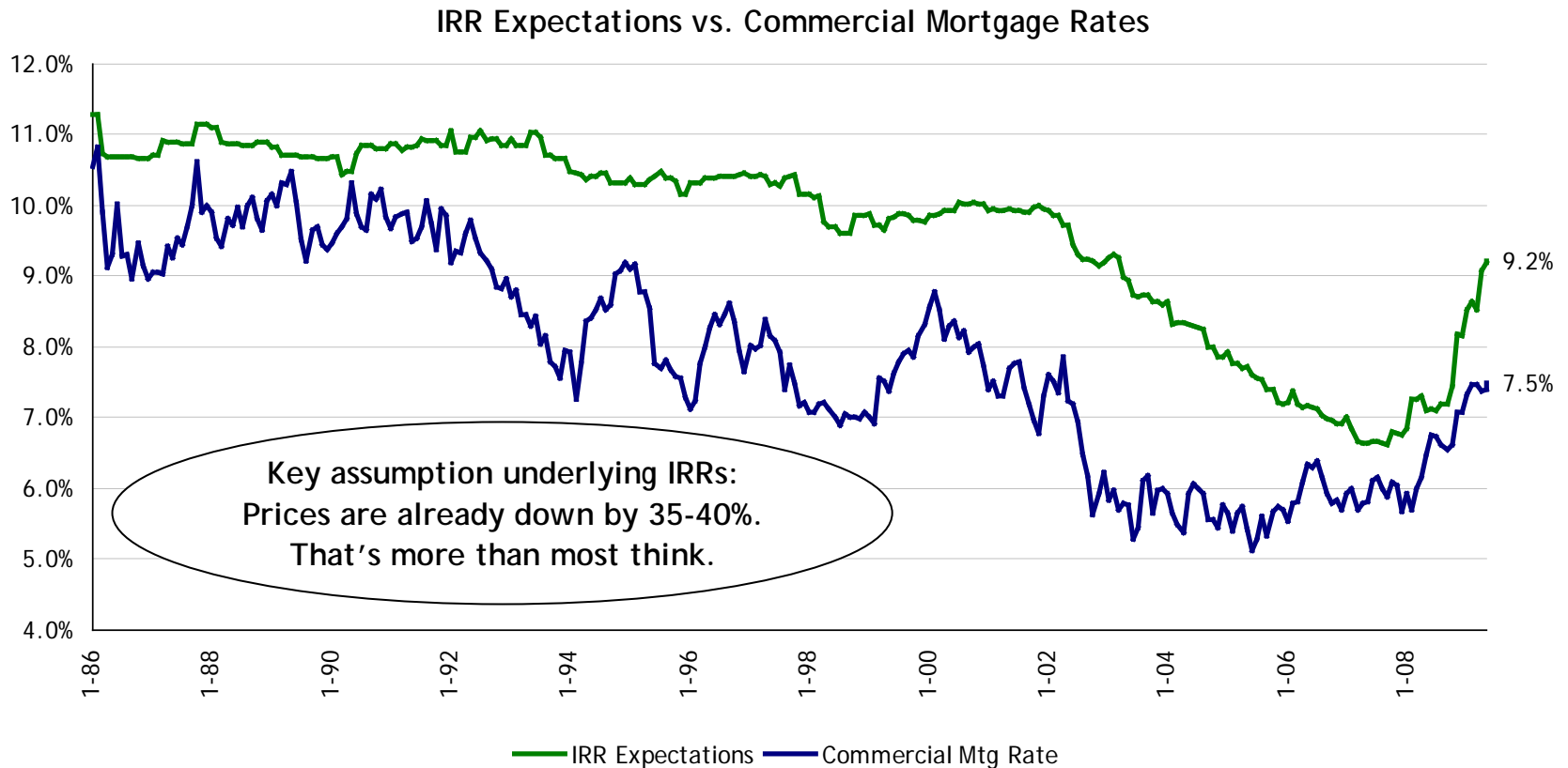
- ❑ Punch #2: Growth prospects have worsened

Estimated Indexed '09-'12 NOI Growth
Major Property Sector Average



Where Should Real Estate be Valued?

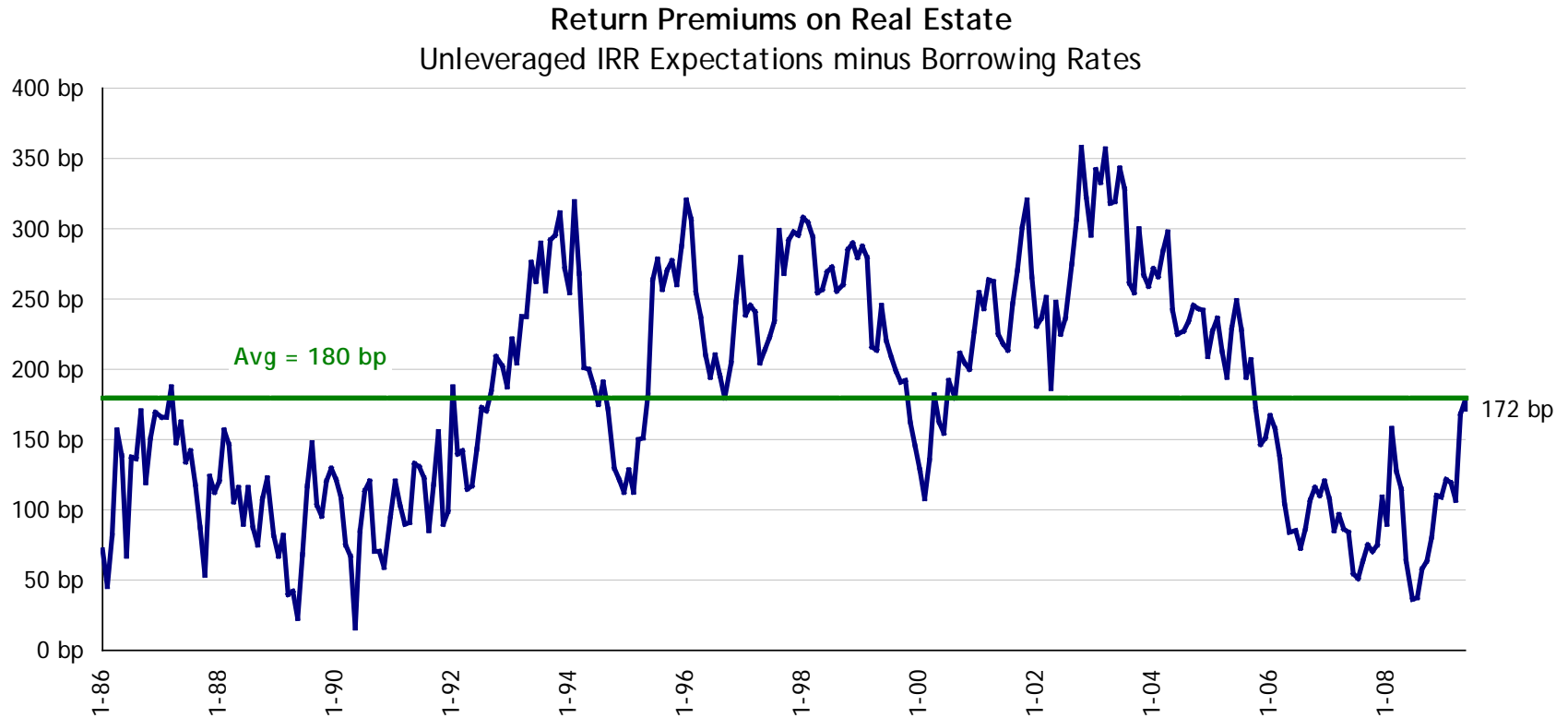
- By combining historic cap rate, intermediate growth, and inflation expectations, it is possible to construct a time series of the unleveraged returns that real estate investors historically have expected to achieve.



Proxy for IRR expectations = economic cap rates + intermediate-term growth + long-term growth (expected inflation less 110 basis points). Inflation source: Survey of Professional Forecasters. Source for Mortgage Rates: American Council of Life Insurers and Green Street.

Where Should Real Estate be Valued?

- Historically, return (IRR) expectations have substantially exceeded borrowing rates. Assuming that values are down 35-40%, the spread is now about back to normal. Real estate is fairly valued if prices are down this much.



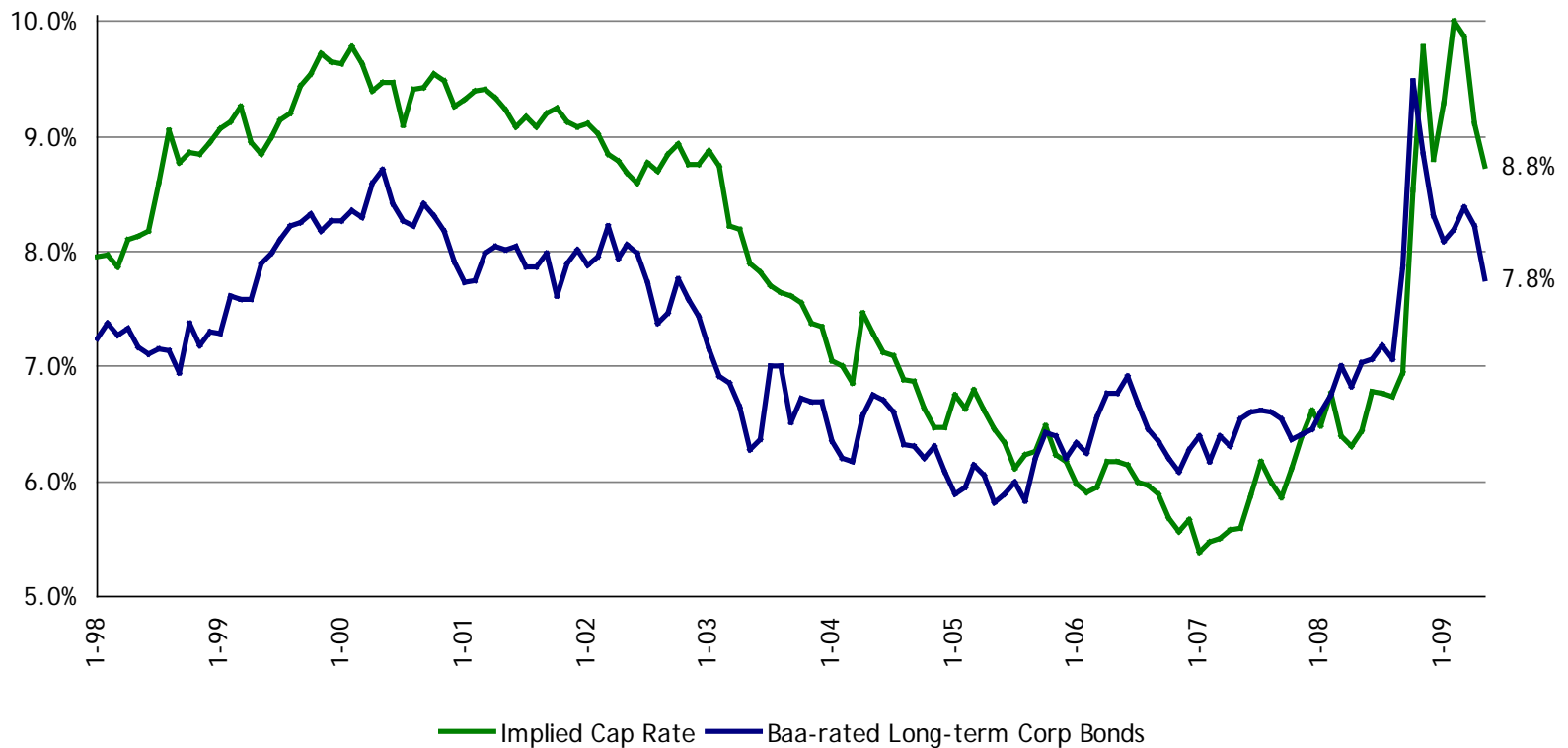
What is the public market saying?

- Public market is a leading indicator
- REIT prices are off 65% from their '07 peak
 - ...even after a 55% rally from their lows (early March)
 - A decline of this magnitude equates to a 40% decline in unleveraged property values
- The decline in REIT prices is much worse than what occurred in the early '90s

Where Should Real Estate be Valued?

- REITs are trading at an implied cap rate (the cap rate at which NAV equals the current share price) of almost 9%.

Implied Cap Rates & Corporate Bond Yields



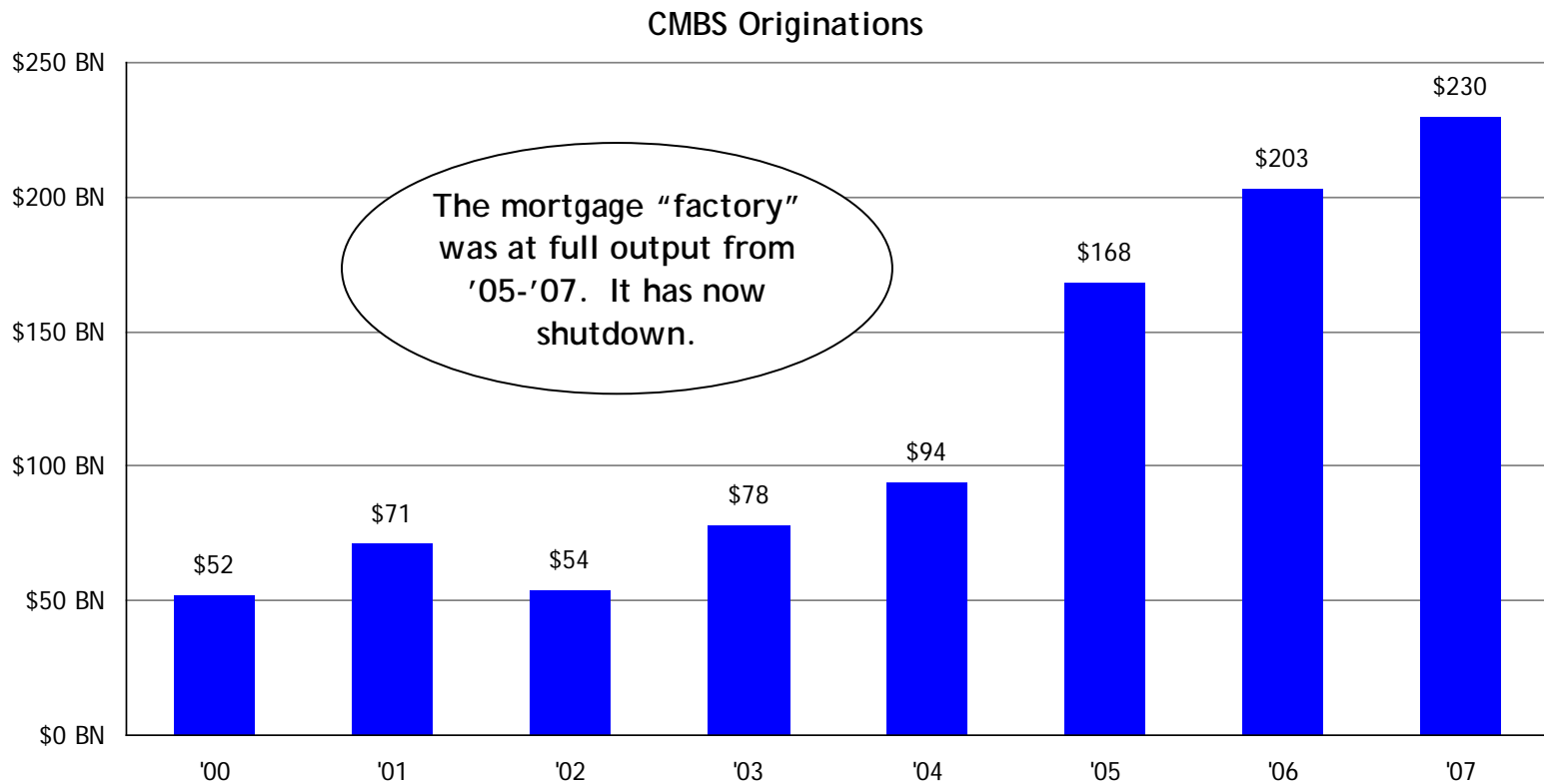
- Two approaches to answering this question lead to the same conclusion:
 - Forward-looking return expectations relative to bond yields suggests a 35-40% correction
 - The public-market says real estate values have (or will) dropped by 40%
- Where real estate **should** be valued and where it **will** be valued are two different questions

Where Will Real Estate be Priced?

- Broad capital markets are recovering, but real estate capital markets are a mess
- This may persist for years...much longer than other credit markets
- Non-existent CMBS market leaves a huge hole in the financing picture
- Distress will be common
- Price corrections often overshoot value corrections

Where Will Real Estate be Priced?

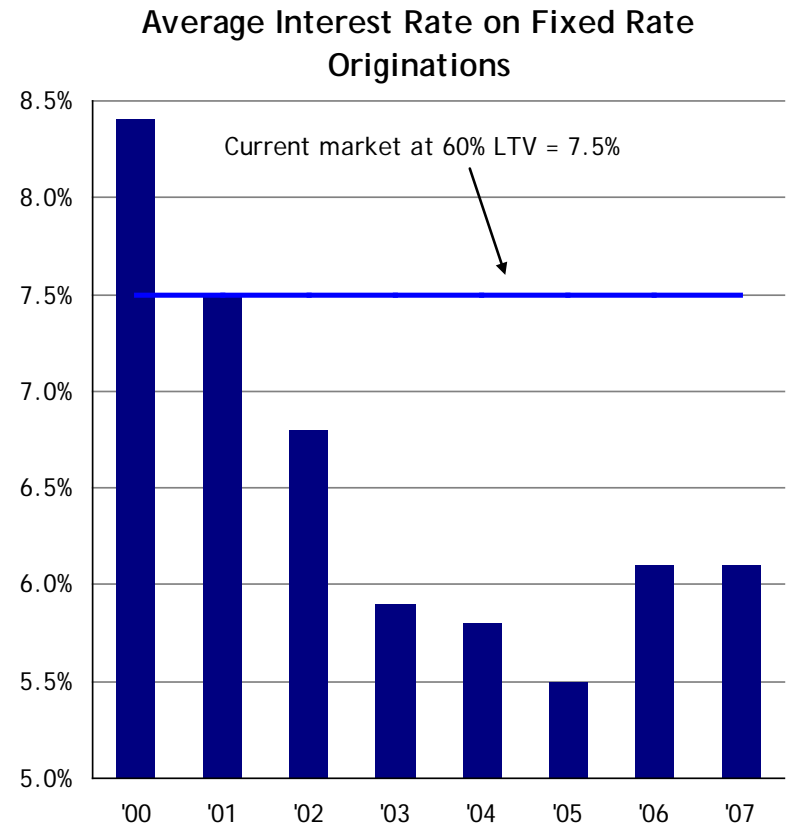
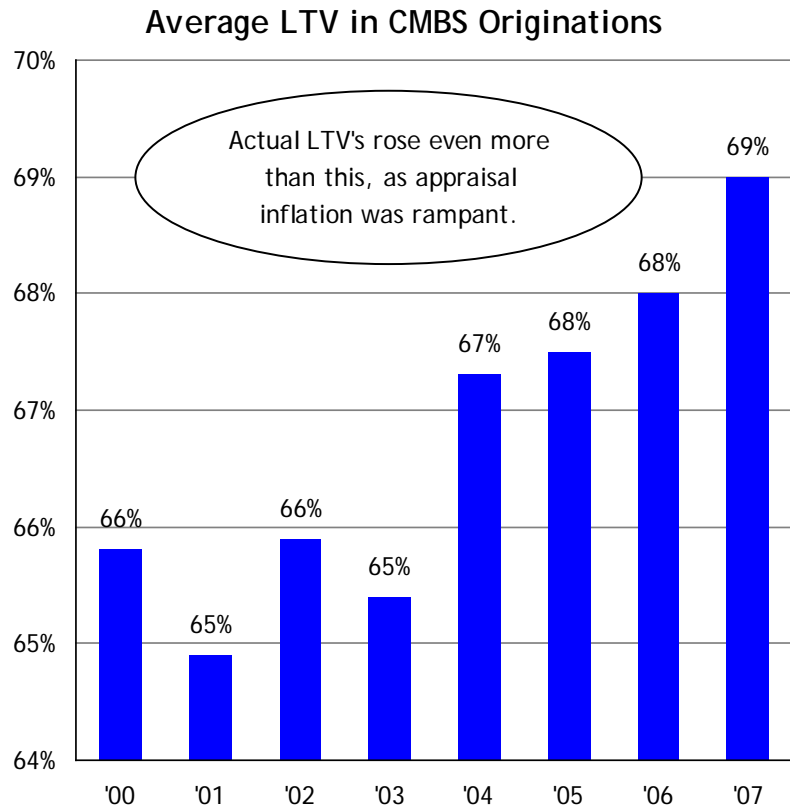
- ❑ The making of a mess: the pace of commercial mortgage originations exploded between '05 and '07 at the same time that underwriting standards became extraordinarily loose. Think of this as commercial real estate's version of sub-prime lending.



Sources: Mortgage Bankers Association, Wells Fargo, Eastdil Secured

Where Will Real Estate be Priced?

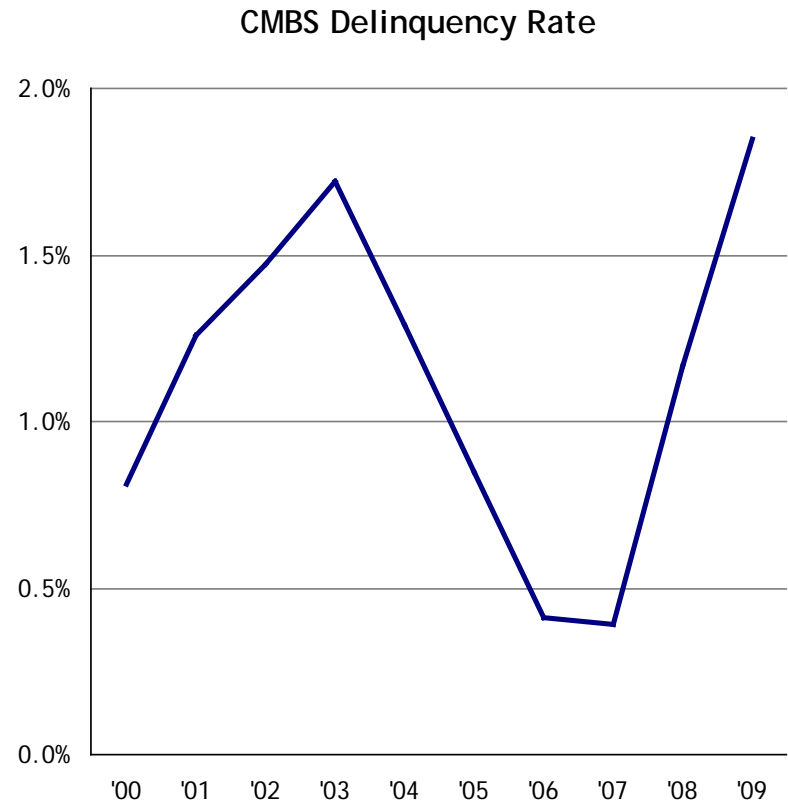
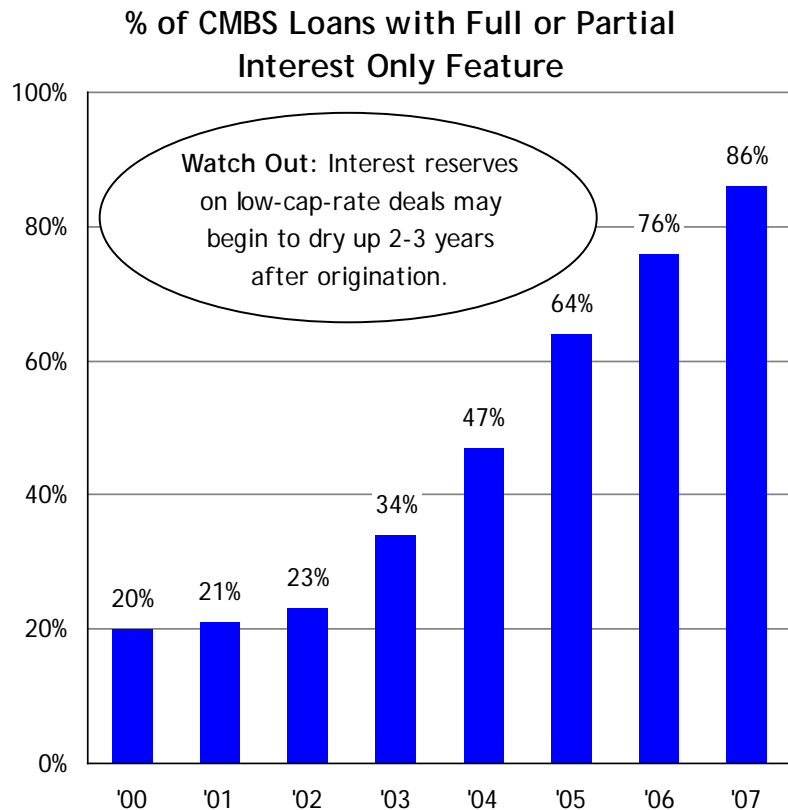
- ❑ The '05-'07 CMBS vintages were underwritten at very aggressive loan-to-value ratios amidst an environment where appraisals were often inflated and borrowing costs were well below current levels.



Sources: Mortgage Bankers Association, Wells Fargo, Eastdil Secured, Green Street

Where Will Real Estate be Priced?

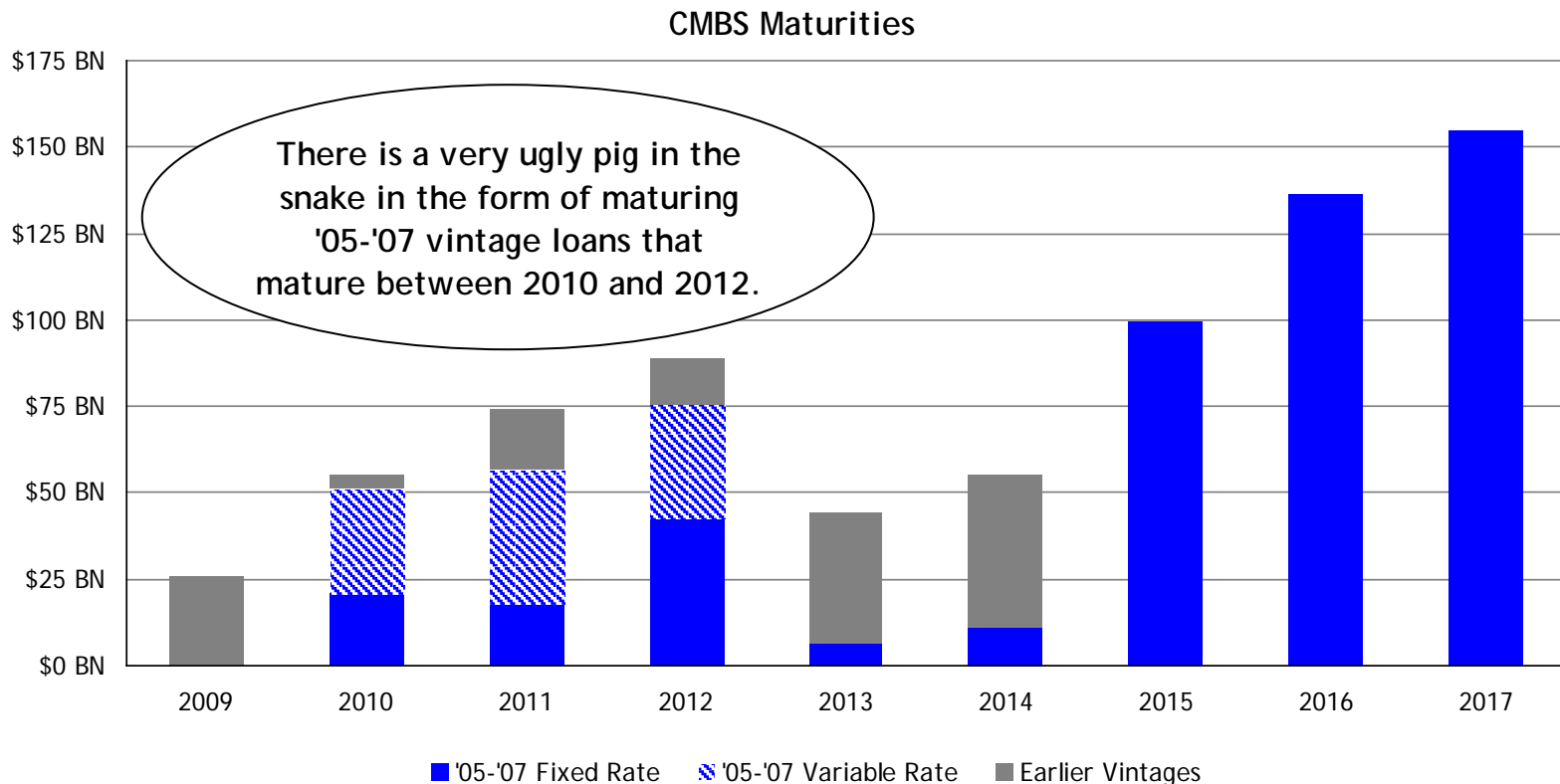
- ❑ Defaults have recently picked up, despite loose terms that called for little, if any, pay-down of principal. They will soon go “off the chart”.



Sources: Mortgage Bankers Association, Wells Fargo, Eastdil Secured. Delinquency rates as of the end of the year; '09 is end of 1Q.

Where Will Real Estate be Priced?

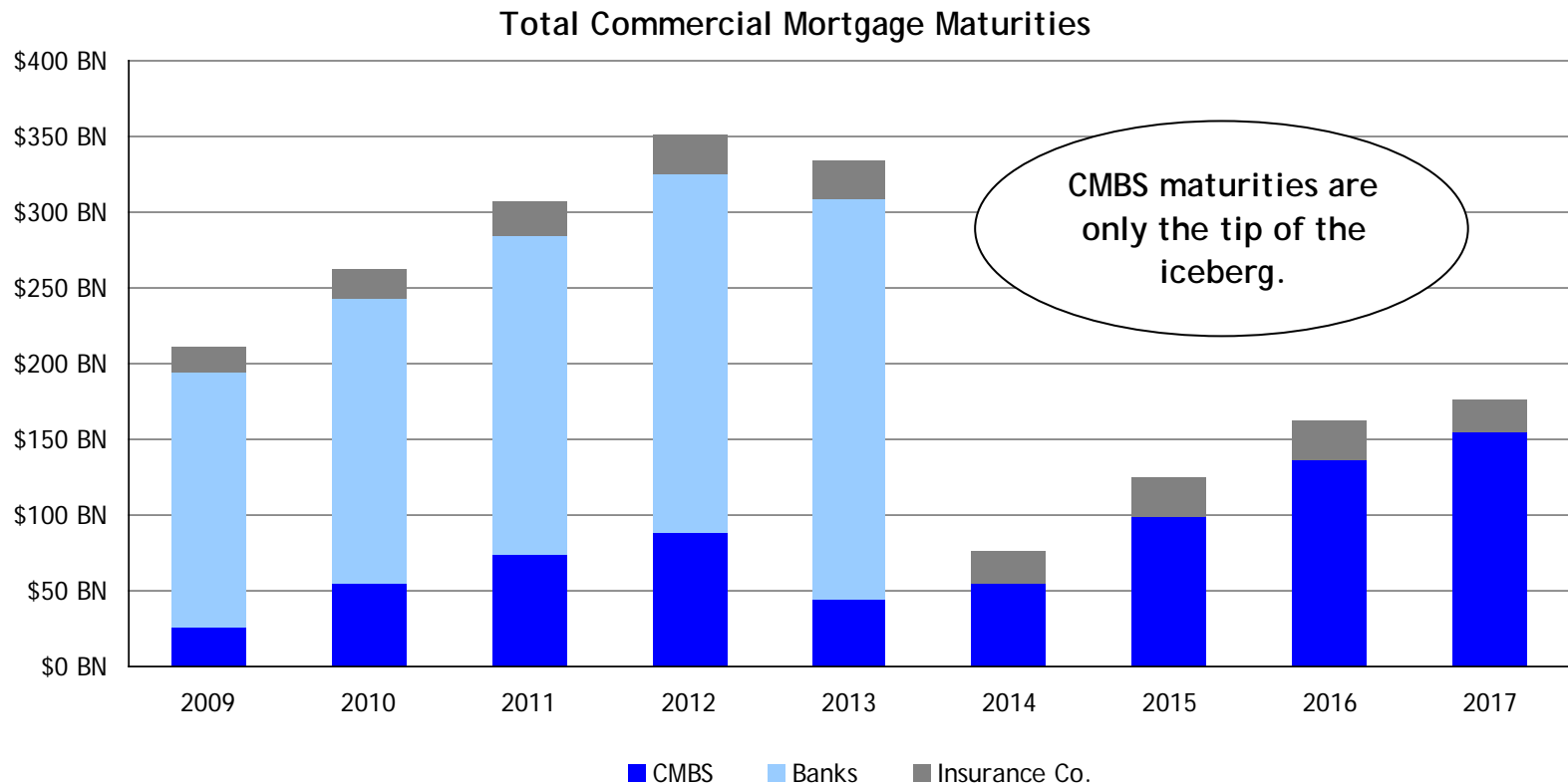
- ❑ This is just the beginning. A large portion of the '05-'07 loans - about \$185 billion of the \$600 billion total - are scheduled to mature between 2010 and 2012, five years after origination.



Assumes extension of extension options on 3-year loans. Sources: Green Street, Mortgage Bankers Association, Wells Fargo, Trepp, Bank of America

Where Will Real Estate be Priced?

- ❑ CMBS maturities will be ugly, but they're only the tip of the iceberg. Over \$1 trillion of maturities occur by '12.

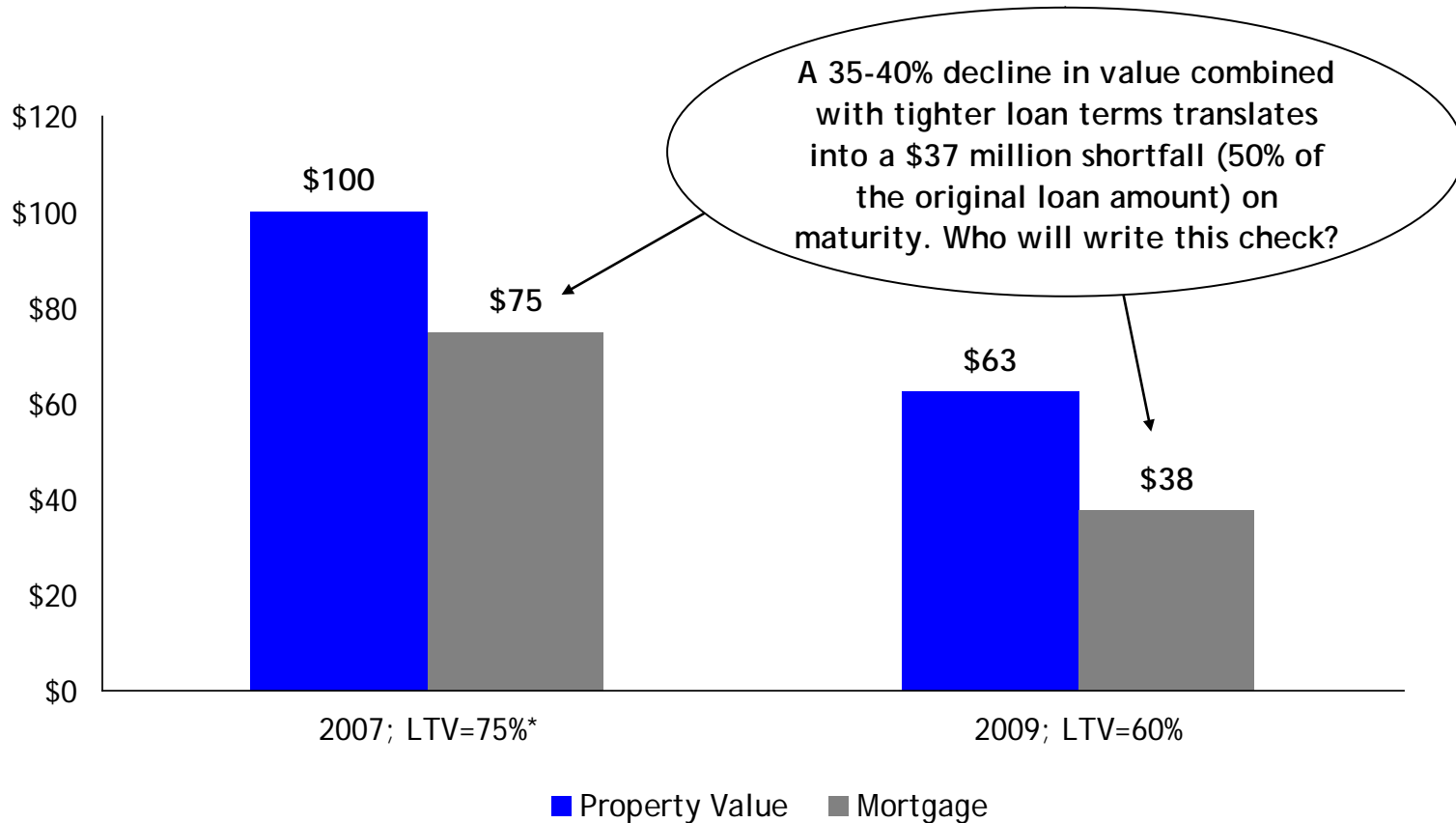


Sources: Green Street, Mortgage Bankers Association, Wells Fargo, Trepp, Bank of America, Deutsche Bank

Where Will Real Estate be Priced?

- ❑ Maturities will be a mess: refinancing will require huge checks.

Mortgage Proceeds on a Property Valued at \$100 Million in '07 vs Now



* LTV calculated off the appraised value would have been lower. Appraised values were often inflated during the boom.

Debt maturity problem is massive

- TALF should help, but not enough
- We need CMBS originations to be large - not likely
- Banks are in de-leveraging/workout mode

Values are likely to overshoot

- Cap rates will stray from fundamentals
- They will be a function of the cost of capital for new owners...real estate market participants need to hope that the REIT rally continues

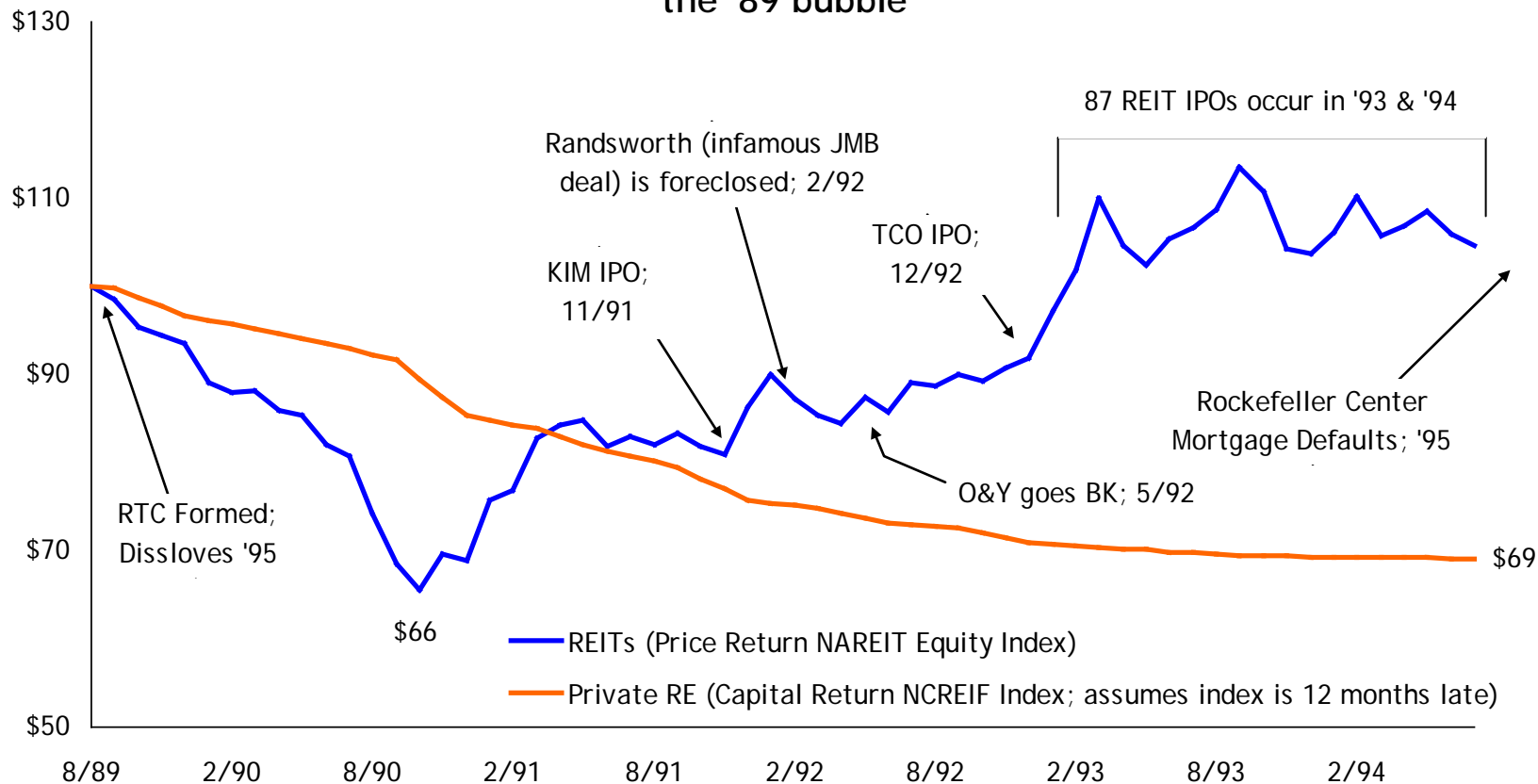
- We've been here before. Commercial real estate imploded in the early '90s
- New equity - primarily in the form of REITs - allowed the industry to recapitalize
- That process has now begun
 - REIT prices have rallied from the trough
 - Re-equitization is underway

Opportunity Amidst Distress

- ❑ Where Will Equity Capital Come From? Public Markets Will Play a Big Role

The History of Our Future?

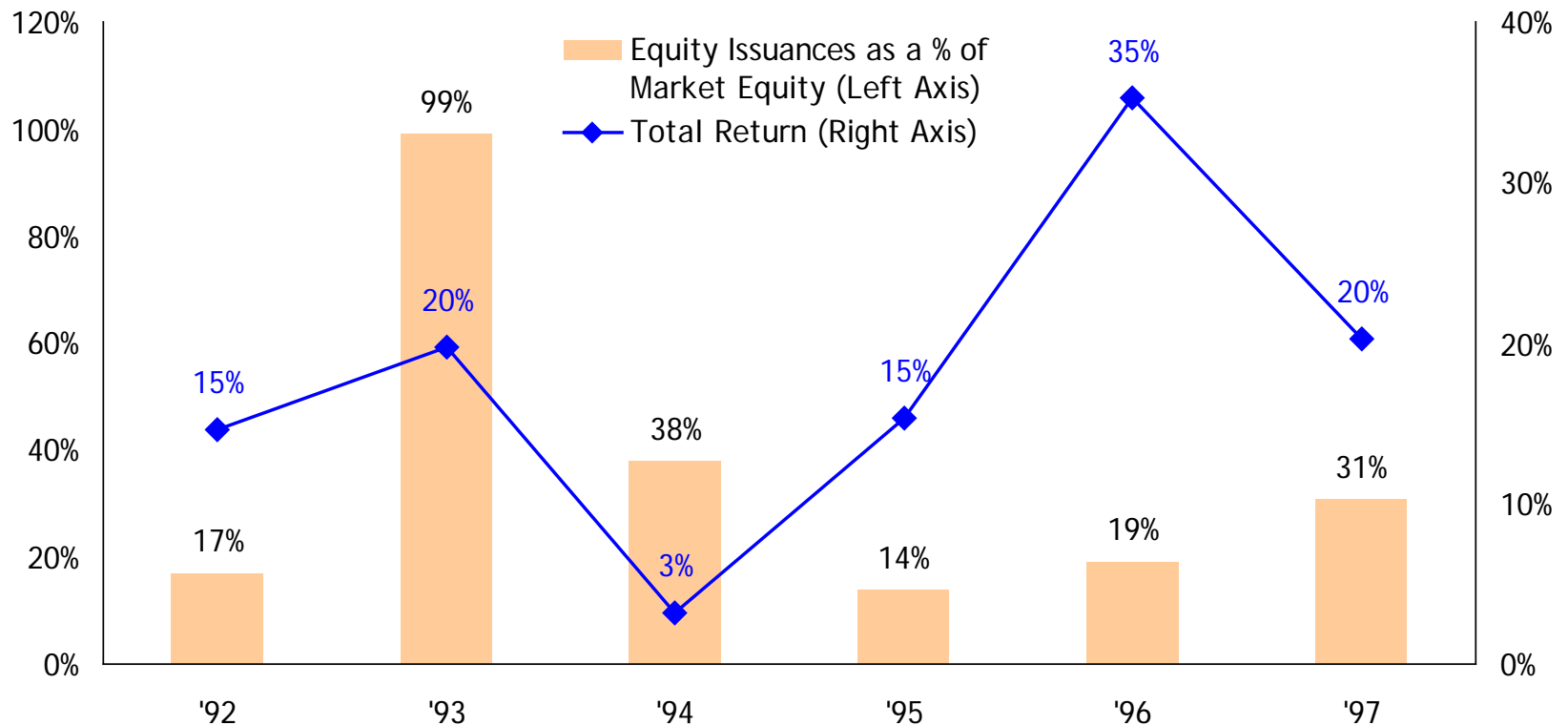
The Value of \$100 Invested in REITs vs. Private Real Estate at the peak of the '89 bubble



Opportunity Amidst Distress

- ❑ The ability to raise capital was a competitive advantage that helped foster impressive performance from '92-'97.

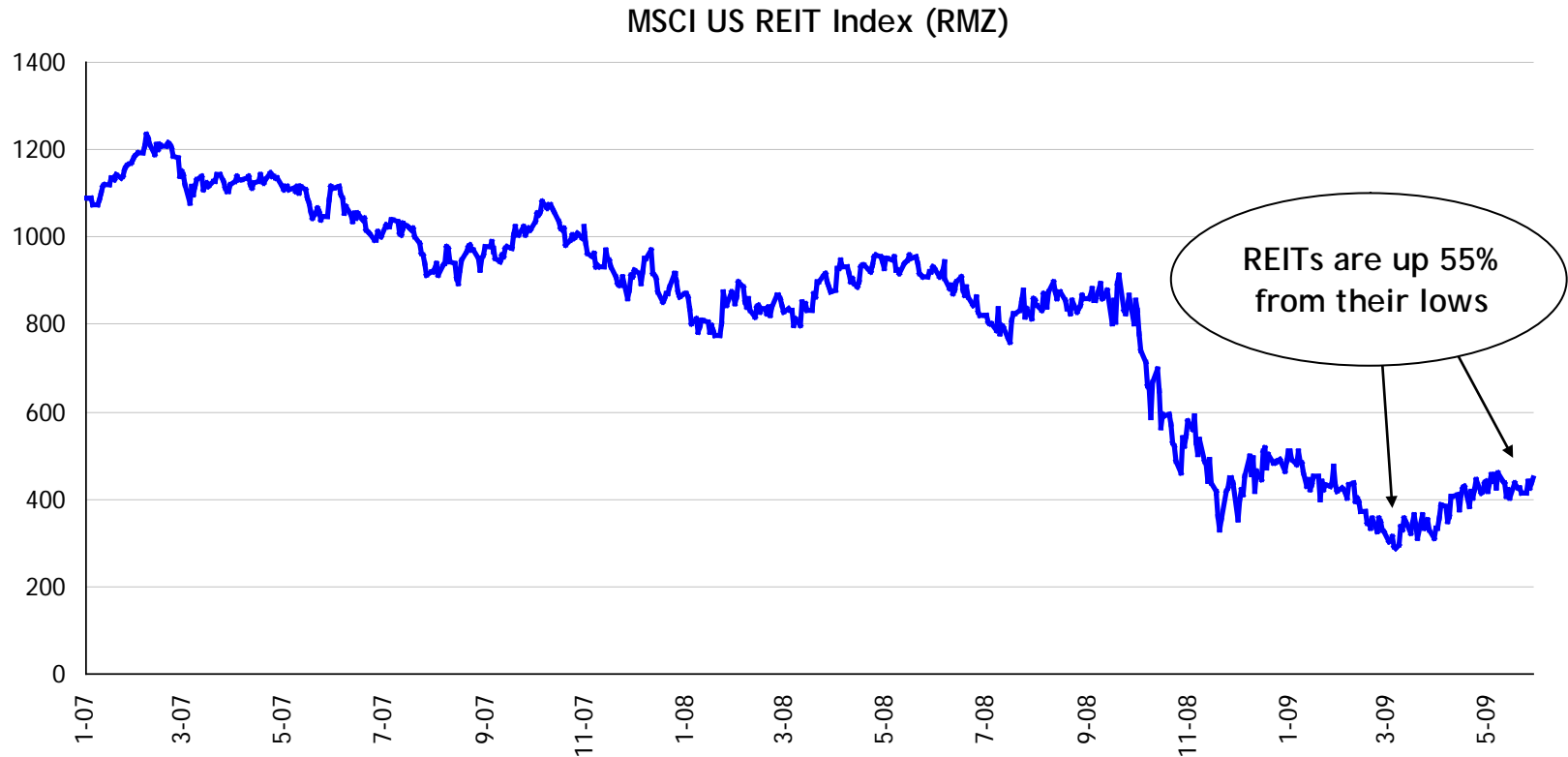
REIT Equity Issuance and Total Returns in the '90s



Source: NAREIT. Equity issuances as a % of market cap at beginning of the year.

Opportunity Amidst Distress

- REIT share prices are up 55% from their recent lows.

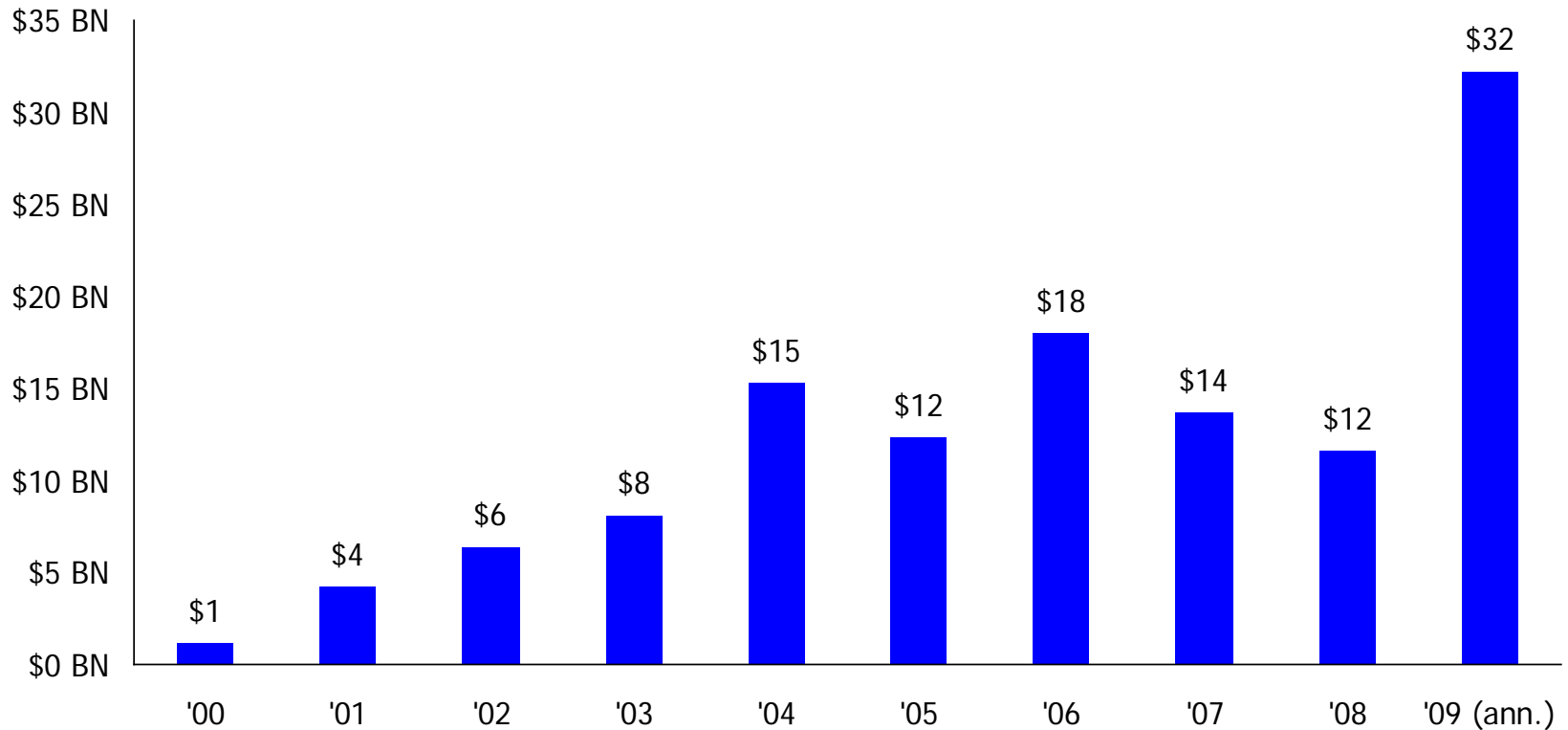


Price index version of the MSCI US REIT Index.

Opportunity Amidst Distress

- ❑ Equity issuance has picked up.

REIT Equity Issuance this Decade



Sources: NAREIT and Green Street. '09 is amount raised thru June 5 and is annualized.

Real estate prices are probably down 35-40% already

- That's more than most are willing to acknowledge
- That's awful news for properties financed with 70+% leverage
- Assuming bond yields stay put, this is "about right"

The next few years will be ugly

- Maturities of underwater mortgages will force fire sales
- Credit markets will recover, but not enough to save the day
- Values may overshoot

Opportunities will Abound

- One man's distress is another's opportunity
- Public REITs will be the biggest winners
- Low supply creates backdrop for solid recovery
- Real Estate is an inflation hedge...that may matter a lot someday

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