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The Crossroads of Commoditization: Back to Fundamentals

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Commentary

Going into 2011, the commercial real estate market has shown a number of signs of an early-stage recovery.

In a preliminary release, the NCREIF Property Index posted strong appreciation in the second half of 2010, with appreciation pushing 10% and total returns over 16% for 2010 as a whole. At the same time, the NAREIT Index posted strong numbers for 2010, pushing an increase of 30% in stock prices for the year. The pace of distressed asset workouts increased also during the second half of 2010. On the transaction front, sales activity has accelerated, although the interest has been focused on the top end of the market.

The commercial mortgage-backed securities (CMBS) industry has shown some signs of life, although it has struggled to find firm footing. Despite some recent activity and signs of an increase in new issuances, the industry is still dramatically off the peak levels reached several years ago, and it is unlikely to reach such levels without significant industry restructuring.

Finally, commercial loan activity has picked up moderately, although again this interest has been concentrated on the top end of the market in terms of property quality and borrower creditworthiness.

While positive news on the real estate capital market and transaction fronts has received significant attention, the spatial side of the market has not kept pace. Indeed, the disconnect between the capital and spatial markets has widened for the past six months.

Vacancy rates have begun to stabilize in some markets, but excess capacity and the overhang of excess space will be a drag on improvement in supply/demand fundamentals. At the same time, rents are significantly below the peak of the market and the levels necessary to justify new construction. Tenants continue to push for rent abatement. They are looking for concessions or inducements to stay in current facilities or to relocate to other facilities that are actively recruiting new tenants.

While some companies are beginning to posture for growth, there are few signs that this will translate to an increase in employment and a need to expand facilities. That said, there are some signs that demand may start picking up for office space, with forecasts for office-using employment growth outperforming the broader industry. However, in many markets, companies are operating with surplus or shadow space that will take some time to absorb.

One interesting trend during this bottoming-out period is a reversal of the commoditization that had spread across the commercial real estate industry during the capital-infused bull run. Briefly, commoditization refers to the standardization of pricing models and yield requirements. These models, however, failed to address fundamental differences in risk and return profiles. This occurred across property types during the run up, as evidenced by the convergence of risk and return, as well as by the compression of returns among core, value-add, and opportunistic assets.

Even if the commercial real estate market recovers at a tempered pace and with an eye on property fundamentals, commercial property owners will find that the rising tide will not right all ships. That is, property types and assets with better supply and demand fundamentals will recover earlier and better than others. In this environment, the compression of capitalization rates, in which the limited numbers of transactions that have occurred

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at the top of the market have been imputed to the broader market, will reverse itself. Riskier assets and those with weak fundamentals and limited appeal to tenants will languish, creating greater separation between the haves and the have-nots in terms of real estate fundamentals. Similarly, riskier property types and subtypes, subsidized by capital providers seeking deals, will struggle for capital and will have to offer higher returns that are commensurate with their risk.

As the transaction market begins to move down the food chain, comparable values are likely to fall with investors demanding higher capitalization rates to compensate for greater inherent property risk. The end result is something of an asset and capital crossroads, where core investors and core properties will travel one path and more exotic or uncertain properties and risk takers will travel down a different path.

The prediction of divergent paths along the risk-return spectrum explains the bifurcated market that has emerged, with a feeding frenzy at the top of the market and a dead zone at the middle and bottom end.

The current situation differs dramatically from the recovery of the early 1990s, where vulture funds and bottom-fishers swooped in to pick up riskier deals and core assets. Of course that recovery benefited from the Resolution Trust Corporation (RTC), which took the hit on prices and made it possible to capture high risk-adjusted returns through market-timing strategies rather than depending on acumen and market fundamentals. One of the reasons the market then turned as fast as it did—and even then it was almost a six-year process—was the fact the middle and bottom end of the property pyramid was so wide and contained the bulk of the assets in the market. This time, attention has been focused on the narrower top end of the market, with hopes that it will trickle down to the bulk of the market—including the commodity space and distressed space still in the queue.

If past history is any indication, the hoped for trickle-down is unlikely to succeed. This is especially true since tenant expectations and demands for space (i.e., energy efficiency, flexibility, accessibility) are likely to be greater, which will elongate the property pyramid and create even more differentiation among strata of the market.

The continued commoditization of real estate and the lack of voluntary transactions (i.e., nonforeclosure or nondistressed) at the middle or bottom end of the market may explain the surprising rebound in institutional property values that is well in advance of an improvement in market fundamentals. The same explanation is likely behind the more sanguine attitude some observers have adopted regarding the much-discussed crisis in distressed assets. Rather than a collapse in values, the industry has been quietly whittling away at the problem and working out some of the distress in the system. Similarly, rather than foreclosing on maturing balloon loans, some lenders have been refinancing loans ahead of maturities and thus appear to have forestalled an even greater crisis.

While the gradual workout of problem assets seems to be a plausible explanation for the apparent recovery in the commercial real estate market, it may well suffer from a fatal flaw. That is, market observers have largely ignored the sampling bias that has occurred to this point in the cycle. Here, *sampling bias* refers to the fact that all three signs of a market recovery have been skewed toward the top end of the real estate market.

On the transaction side, risk-averse investors have been drawn like moths to a flame toward the top end of the market, resulting in competitive bids and some record prices. Unfortunately, the spatial market does not have much bandwidth at this end of the spectrum, suggesting that investors will have to work their way down the quality chain to source product, and they will face additional risk in the process. This situation remains unstable. The absence of clear demarcations between quality zones has made it extremely difficult to assign accurate risk or adjusted values to many properties. This uncertainty has added risk to the market, and the market has yet to come to terms with how to adjust to such risks.

Another sampling bias that has yielded false signals has occurred with respect to distressed-asset workouts. The initial phase of voluntary workouts of problem assets focused on solid assets that do not emanate from poor asset quality or poor fundamentals, but arose from externalities that may be reversed when the tide shifts. One could argue that lenders should adopt a bipolar attitude toward distressed assets and workout ones at both the top and the bottom of the continuum to clean up their portfolios. While that strategy makes some sense, it has not occurred. Lenders have been reluctant to take portfolio hits that could call attention to more widespread problems possibly lurking in their portfolios.

Finally, sampling bias exists in the area of loan refinancing. The loan refinancing that has occurred has focused largely on solid assets and relationship business. Borrowers with troubled assets that are unlikely to recover due to weak fundamentals, or borrowers that have no net worth or track records to bolster their credit, are still hoping that the market will rebound, the path will straighten out, and lenders will loosen the purse strings to help fuel the recovery.

Until the dust settles, there will be a number of opportunities for savvy investors with real estate acumen and access to capital. However, not all players will have the same forecasts and the knowledge necessary for rebound investing. The crossroads of decommoditization will make for interesting times and ultimately may lead to a return to fundamentals.

The Economic Environment

The good news is that the economic recovery appears to be on more solid footing and a double-dip recession now seems unlikely. The commercial real estate market, however, is likely to face significant headwinds and lag the economy.

The Federal Reserve has made it clear that it will continue to hold interest rates down, which will be critical to both the economic recovery and the real estate market. At this point, it appears the market is discounting gross domestic product (GDP) growth in the 3%–3.5% range, which is on par with recent projections. Consumers did their part during the critical holiday season, although their willingness to return to the registers could evaporate if the economy does not continue to grow or if the stock market flounders.

On the corporate front, conditions are improving, especially for large businesses; strong balance sheets and increasing stock prices are providing a much-needed boost. Although business investment has picked up moderately, small businesses still are tentative and likely to struggle with credit requirements.

The major drags on the economy are the housing market and employment. These two issues are clearly related and both face an uphill battle. Indeed, a spate of new foreclosures is likely to put downward pressure on housing prices over much of the year as the inventory of problem properties is gradually worked off. Political divisiveness is particularly troubling, especially since the economic turnaround that has occurred can be attributed in large part to the federal government's stimulus programs. While receiving much criticism, these programs helped place a floor under the economy and prevented it from slipping into a depression, which was a distinct possibility in the not-too-distant past.

Economic Growth

The economy has continued to build some momentum, as evidenced by upward revisions in GDP growth and forecasts for further improvement. While modest compared to other recoveries, the improvement is significant in light of the continued struggles on the housing and employment front. The strong corporate balance sheets and profits suggest that companies are well positioned to provide added stimulus to growth. The economic recovery is fairly widespread, with the number of markets in a recovery mode outpacing the combined number of those in a recessionary mode.

Some of the increase in GDP has been attributed to increases in inventories as companies anticipate further economic improvement. One contributor has been late-2010 retail sales, which helped improve year-end figures and add momentum. Neither of these stimuli will continue, however, unless other economic indicators continue to improve confidence levels.

Confidence has been bolstered by advances in leading economic indicators, and by confirmation of the federal government's continued commitment to protect the economic recovery. This was evidenced by support for Federal Reserve Chairman Bernanke's plan to buy long-term Treasuries over the next six months. While this capital infusion will help the recovery, it will not provide much relief on the employment front, which will continue to weigh down the recovery and lead to other efforts to improve employment growth. One effort to improve employment was President Obama's call for a government-wide review of federal regulations to identify rules that are inhibiting economic growth. In his State of the Union address, the president reassured the American public that the economy is on solid ground on the road to recovery. He also committed to making the difficult decisions that are needed to get the deficit under control and to leading the country down the "global road" that defines the future world.

While the federal government will do its part to stimulate the economy, the road will not be easy and the political landscape will remain a challenge. The good news is the federal government still has some gas in its tank in terms of the road ahead. The same cannot be said for local and state governments, most of which are facing severe budget crises. This situation began to hit home in 2009 when state and local tax revenues fell for the first time in almost a decade.

On average, state tax revenue fell almost 10% in 2009, a figure that is likely to have expanded in 2010. The budget squeeze has been particularly pronounced in states that depend on revenue growth to support basic services; many these states were also the hardest hit by the collapse of the housing market and face a rocky road to the future. As a result, states have adopted severe budget cuts that have led to cutbacks in basic services, which hit the disadvantaged the hardest. Other cuts, in education and infrastructure, will have a more enduring impact on global economic competitiveness. Unfortunately, the situation is so dire that planning for the future has taken a back seat to solvency for many state and local governments. Although an increase in federal grants has helped offset some state and local losses, it is unlikely the federal government will provide bailouts in light of the pressure to get the federal deficit under control.

International Economic Concerns

In addition to internal challenges to economic recovery, there are also challenges emanating from offshore. These global challenges were addressed at the 2011 World Economic Forum Annual Meeting in Davos, Switzerland.[1] The overall theme of the conference was "Shared Norms for the New Reality," which called for greater collaboration and a definition of the emerging new norm—economic rebalancing. Shifting from a defensive mode, global leaders have also shifted attention to the future, with several announcements made to establish a roadmap to global prosperity. This was evidenced by several initiatives such as creation of the global Risk Response Network, which would address mounting concerns regarding economic inequalities and the failure of global governance systems. The global discussion also pointed out the complexity of managing the wide range of risks (e.g., financial governance, cyber security, resource scarcity) that are intertwined.

The dramatic differences in growth rates across the globe were also noted, along with recognition of some of the economic rebalancing that is likely to occur between developing countries on the slow-growth path and emerging markets on the fast track. The United States was also singled out as the gorilla in the room due to its failure to address its expanding budget deficit.

Many countries are facing severe economic and financial crises that put emphasis on near-term survival. While such concerns are fairly widespread, they are particularly acute in the Euro Zone, where a number of countries have not been able to keep up with the European Union's standards for stability and growth. Indeed, the combination of high debt and stagnant growth has driven down the value of the euro and has left some countries on the financial brink of collapse. While the U.S. economy is in better shape than many of these countries, its fate is increasingly tied to that of other nations. Over the near term, global turmoil in developed nations will place a damper on exports and put additional stress on the trade deficit. However, the dramatic increase in growth in emerging markets and the increasing appetite for resources will help drive export opportunities.

Although the road ahead remains somewhat clouded, it is clear that the global shift from the West to the East will create both challenges and opportunities in terms of resources and capital deployment that will affect the domestic economy.

1. For details see http://www.weforum.org/content/pages/davos-2011-highlights-wednesday-26-january.

The good news is that attention has been focused on these issues. This suggests that in the absence of unexpected surprises, prospects for GDP growth in the United States remain solid and the economic recovery should stay on track.

Employment

Going into 2011, the dismal outlook for employment was seen as a creating a prolonged drag on the economy by weighing heavily on business and consumer confidence. This situation would likely have been much worse if the federal government had not pulled out all the stops to avoid a collapse. While arguably placing a bottom on the decline in employment, the federal stimulus programs were not sufficient to make much of a dent in the unemployment rate, which hovers under 10%.

There are some positive signs, however, that suggest the employment crisis may have peaked. For example, the pace of involuntary separations has flattened out. The same is true for the voluntary separations, which is understandable at this stage of the cycle where there are few opportunities for new jobs. On another positive note, a recent survey revealed that an increasing number of companies intend to start hiring over the next six months. While that is welcomed news, workers are unlikely to enjoy much in terms of raises and this will place a governor on retail sales and consumer confidence.

Looking forward to the longer term, when the economy and the pace of employment does pick up, wages might increase ahead of the curve. This increase could come as companies scramble to retain the historically high percentage of disgruntled employees who have been trapped in their jobs. Many of these employees have been pressured to increase productivity in the face of flat incomes and declining benefits, and this has created a disaffection that will lead workers to seek new opportunities when the market turns around.

Despite widespread anticipation of a gradual decline in unemployment figures, there is some concern that unemployment totals may actually be worse than the published numbers. This concern stems from the fact many long-term unemployed workers have dropped out of the workforce. This shadow unemployment segment is likely to create a drag on unemployment figures when the economy picks up and those who had given up re-enter the workforce.

Even without considering the hidden unemployed, the data reveals the severity of the plight of many American workers and the uneven impact on certain segments of the workforce. The prospects for moderate and selective job growth will favor the top end of the employment pool and offer little hope for the bottom end of the ranks of the unemployed. Unfortunately, any trickle-down where economic expansion results in job growth across the spectrum of workers is unlikely to occur in the next several years. At the same time, the heated debate surrounding extension of unemployment benefits for the long-term unemployed calls into question the future of support for those left behind. Unless some longer-term solution is developed, the extended benefits that have been a lifeline could evaporate. This situation could place additional pressure on state and local social services and benefits that are hard pressed to meet current needs within current budgets.

Inflation and Interest Rates

While there is some concern over inflation, there are no signs that inflation will spike. The upward pressure on commodity, food, and gasoline prices will be closely monitored, however. In terms of food, retail prices are expected to rise above the rate of inflation. On the other hand, prices for dining out, which are a significant share of overall food budgets, are expected to be stable due, in part, to low labor costs. Energy prices will be something of a wild card, with unseasonably cold weather straining budgets and resources, and with gasoline prices trending upward. At an overall level, retail price increases should be manageable and tempered by a moderation in demand as consumers wait for improved economic conditions to show up in their paychecks.

At its January 2011 meeting, the Federal Open Market Committee (FOMC) continued to stay the course, indicating it would hold interest rates at record lows to allow the economy to gain additional momentum. In its press release, the committee recognized the recent increase in consumer spending, but it also noted that consumer sales would be moderated by nagging unemployment, stagnant income growth, the continued housing crisis and loss of home values, and credit constraints. On the business front, it noted an increase in spending, but a reluctance to add employees and a continued softness in nonresidential construction.

Despite recognizing the recent increases in commodity prices, the FOMC's outlook for longer-term inflation was stable and pointed to a downward trend in underlying inflation factors. It emphasized the importance of balancing employment growth with price stability. The committee announced that it would keep the federal funds rate in the 0%–1/4% range. It also reaffirmed its commitment to reinvest principal payments from its securities holdings and its plan to purchase $600 billion of longer-term Treasury securities by mid-2011. These efforts are focused at holding mortgage and corporate bonds rates in check.

Going forward, the combination of low inflation and interest rates are expected to stimulate the economy and have been fully discounted into business and investment decisions. Since a change in expectations for inflation and interest rates could have a dramatic impact on the economy and investment decisions, these factors will continue to be closely monitored, with minor changes evoking quick responses.

Business Indicators

Manufacturing activity picked up in the 2010 third quarter as companies responded to increases in factory orders and positioned themselves to take advantage of the expected increase in demand for finished products. Although tapering off later in 2010, orders and shipments remained strong compared to the trough in early 2009. While inventories were a bit of a drag on the economy in late-2010, inventory-to-sales ratios are expected to improve.

At this point in the recovery, many manufacturing companies are trying to push productivity improvements to the limit and hiring temporary employees to hedge against softening demand. They are also taking advantage of excess capacity in plant and equipment that has been carried during the recent downturn. The service sector has also improved and is postured to take advantage of the opportunity for additional gains.

In terms of growth potential, corporate America is well positioned, with strong balance sheets and excess capacity. Improvement in the stock market has also strengthened business prospects and provided an additional stimulus to the economy, trending upward in the 2010 fourth quarter after struggling for a floor for much the year. That said, the road has not been smooth and has not carried all sectors. For example, small businesses continue to be a cause of concern. With more at risk in terms of survival, and no government aid for them, small businesses will remain guarded and reluctant to take a leadership role in the economic recovery. However, due to their entrepreneurial spirit and ability to act decisively if they have access to capital, small businesses can be expected to quickly join in the rally once it has left the station.

In addition to small businesses, the financial services industry will be closely watched. To this point, the industry has made a remarkable recovery, which has been good news for taxpayers and has helped dampen the cost of the bailout. However, the outrage over industry practices and the failure to resolve those issues has placed financial services on the watch list for many politicians and investors.

In terms of downside risk, the financial services industry will face a number of changes that could put a damper on business. For example, over the next eighteen months more than 100 studies will be released, and rule changes will be introduced to comply with the Dodd-Frank Act. The scope of these rule changes is widespread, ranging from securities origination, packaging, and distribution to compensation limits and economic incentives.

While attention will be focused on the financial industry, companies in all sectors will have to address the call for greater transparency and accountability. They will also have to conform to global practices and reporting requirements that are being established. While these changes will present some challenges, they should also help position the country on the global stage and map out a path to global success. The bottom line is a relatively healthy and stable near-term outlook for businesses, with some upside potential.

Consumer Confidence

Consumer confidence levels have bounced around, with no clear trend. Confidence levels remain mired well below long-term averages and signal that consumers continue to be bothered by the hangover from the prolonged collapse of the housing market and lack of improvement in employment. Offsetting some of these concerns has been the recovery in 401(k)s, which have benefited from gains in the stock market. The change in federal tax withholding rates and the extension of tax cuts have also provided a modest boost to take-home pay. Unfortunately, these increases have not been enough to replace the loss of wage gains which consumers have to see before confidence levels start moving back up to their long-term averages.

As with businesses, consumer have discounted low interest rates and inflation expectations, which places additional pressure on the Federal Reserve to maintain rates at historically low levels. While inflation should remain modest, changes in gasoline and fuel prices will be closely monitored as consumers focus on essentials and watch their purse strings. Consumers will remain guarded until employment turns around and the housing market shows signs of improvement, neither of which is expected to occur in the near term.

Retail Sales

The 2010 holiday season was a cause for celebration among retailers and retail investors. Sales figures were particularly strong for luxury goods, with customers likely celebrating the recovery in the stock market that helped bolster depressed portfolios. Wholesale clubs also enjoyed strong sales, with value still on consumers' minds. The non-store segment continued to outperform other shopping formats as it has the past several years, although the market share still remains rather limited compared to traditional formats. As might be expected, personal care expenditures were also strong along with selected merchandise lines that addressed pent-up consumer demand and offered an attractive value proposition. Apparel sales, which are a bellwether for the retail industry, were somewhat disappointing, although customers turned outside of traditional apparel merchants to satisfy demand.

Durable goods sales were off in 2010, with automobiles taking a step back after some early success with the new model year. Despite a significant increase in hybrids and smaller, high-mileage vehicles, auto buyers have been reluctant to leap into the new technology. Rising gasoline prices might change that equation going into summer, although the economic recovery and consumer expectations may dampen demand. That will place automakers under more pressure to motivate buyers to ante up to help meet stringent energy-efficiency guidelines that are looming in the not-too-distant future.

Going forward, retail sales are expected to trend upward on pace with the broader economic recovery. If the recent trend in economic growth gains more traction, consumers may be more willing to increase spending in the second half of 2011. However, there are some significant downside risks if the economy stumbles, employment growth slips, the stock market loses momentum, or the housing market fails to show signs of bottoming out.

Housing Market

After a brief rally in the 2010 third quarter, the housing market lost additional ground, with housing prices trending further down in most markets. Some of the lost momentum was expected as the home-buyer credit programs wound down and existing-home sales dropped. Low interest rates and prices have drawn some buyers to the market, but most feel no pressure to act and are willing to wait until the market sorts it out. After a fleeting period of optimism in mid-2010, homebuilder sentiment also slipped back down toward record lows. This situation does not bode well for the industry, especially as it moves into the peak home-buying season.

One of the major drags on the housing market is the hangover from foreclosures and the prospects for an increase in foreclosure activity as the industry sorts through the documentation and paperwork issues that were in the forefront last year. After a brief respite that was partly a measured response to thwart dramatic government interventions, banks and mortgage servicers have given notice that they are resuming foreclosures and will be more aggressive in dealing with problem assets. This is bad news for the industry with some four to five million loans in the seriously delinquent category (technically in default). Without additional government intervention in the near term, some two million additional households may face foreclosure in 2011.

A dramatic increase in the number of foreclosures and the subsequent sales of distressed assets should place additional downward pressure on existing home prices that have already been dragged down by the surge in foreclosed properties. Last year, foreclosed property accounted for a third to a half of housing sales; given the lack of transaction activity, the market share of foreclosed properties should continue to increase during 2011. The pace of foreclosures will be dragged out, in part due to capacity constraints in the system. As such, beleaguered housing market conditions will remain for some time.

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In the too little, too late category, the Federal Housing Finance Agency (FHFA) is continuing to explore additional changes in the way banks manage home loans to help ameliorate the crisis. While the details are unknown, some changes are likely to focus on the cost-benefit equation in the current system, which FHFA argues makes it more expedient and profitable for loan servicers to foreclose than to work out a solution with struggling homeowners. The changes could range from regulation of current behavior to restructuring of loan servicer compensation agreements to provide more incentive to work out problem loans without requiring troubled borrowers to cover added fees that often exacerbate workouts.

Another proposed reform that could impact the supply of capital would be a requirement that originating banks retain a portion of securitized loans to ensure they retain some skin in the game and have a vested interest in managing the life-cycle risks of mortgages. Such a change would force banks to tighten underwriting standards and return to some of the fundamentals lost during the boom times; the change may also put upward pressure on spreads to compensate for the incremental risks

Another issue Congress will have to deal with is how to restructure Fannie Mae and Freddie Mac. The future of the two government-sponsored entities (GSEs) will have huge impacts on the future of residential finance. When coupled with the Federal Housing Authority (FHA), the GSEs accounted for some 90% of home loan activity. However, before determining the fate of the two entities, the government will remain on the defensive defending top executives at the two firms. Indeed, a recent report stated that the federal government has spent some $160 million of taxpayer money defending top executives at the two firms since they were placed in conservatorship in 2008. This is on top of the $50 million or more the entities spent. The outrage and finger-pointing that has already occurred suggests the debates will be heated. On one side will be those who believe the federal government should not be in the business of providing guarantees. On the other side will be a consortium of housing proponents, mortgage industry leaders, and housing advocates seeking to insulate homeowners from additional constraints on the system.

Although it is not clear how the reforms will play out, the housing finance industry will likely face dramatic changes during 2011 that will affect the housing market. If the government scales back its guarantee and insurance programs, spreads are likely to increase for borrowers with lower credit ratings, putting upward pressure on mortgage rates. In addition to affecting access and prices of mortgages, new rules and regulations are likely to change how the existing mortgage infrastructure operates, causing disruptions in loan origination, loan securitization, and loan servicing processes.

Many of the mortgage industry changes are long overdue and will provide stability to the housing finance market over the long term. Unfortunately, the industry will not benefit over the short term and reforms will be too late for homeowners who are in the process of losing their homes. As such, the housing industry will face some additional downside risk associated with uncertainty surrounding the future of residential mortgage finance. When coupled with tempered demand for housing and carryover from the financial crisis, the reforms will put a damper on the housing market recovery beyond what some had projected.

Real Estate Market

Overview

The commercial real estate market has been fairly stable at the spatial level, with vacancy rates and rental rates generally leveling off across property types and markets. The plateauing in vacancy rates can be attributed to a decline in delivery of new product rather than an increase in demand. Some markets and submarkets have experienced an uptick in demand associated with relocations and movement of existing tenants rather than an increase in demand. This situation is expected to continue even after employment levels begin to increase due to excess capacity and phantom space.

The steady-state market environment still faces downside risks that belie the dramatic rebound in investment performance seen across property types in both the public and private markets. For example, for the industry as a whole, the FTSE NAREIT Index reported a 28% total return through the end of 2010. This figure edged out the 2009 total returns, which came after two consecutive years of negative performance that had a cumulative negative return of some 55%.

On the private side, the NCREIF Property Index for 2010 showed slightly over 16% total returns. This came on the heels of a disappointing 2009, when total returns were down more than 16% and trailing three-year figures were down more than 3% per year.

The divergence between spatial performance and returns suggests that investors are anticipating a rebound in performance as fundamentals play catch-up. While there is likely to be some improvement in fundamentals as development remains in abeyance and demand gradually picks up, there are few who are projecting a spike in market fundamentals that would come anywhere near the spike in asset prices.

The widening divergence between spatial market fundamentals and capital market performance can be attributed in part to a flight to quality that has taken investors' eyes off the road. This has caused capitalization rates for top-tier properties to decline, which has rippled across the board. The resultant increase in market values has shifted emphasis away from current dividends and cash-on-cash income returns to the appreciation or capital gain component of returns. This shift in emphasis is ironic in the sense that growth vehicles are inherently riskier than income vehicles. It is also the opposite of public statements that institutional investors have made as to their shift in focus to risk-averse, core strategies in response to disappointing performance in value-add and opportunistic investments. This trend suggests that investors have either developed a willingness to settle for less or they hope to capture more returns down the road as spatial fundamentals improve.

At this stage of the cycle, the commercial real estate market is at a crossroads, with one path leading to convergence of the spatial and capital markets and the other leading to a new norm where investors will conclude that less is more in real estate. Since real estate ultimately must compete with other asset classes for allocations, there will be downward pressure on values until fundamentals turn around. This will create downside risk at a time when investors are eschewing risk. The potential for repricing of assets outside of those at the top suggests that investors will have to be patient and keep buckled up for what may well be a wild ride. Unfortunately, investors are generally finicky and looking more for instant gratification, especially when it is available in other asset classes.

Office Market

Over the long haul, the office market has been the highest property-type allocation among institutional investors. This high market share can be attributed to a combination of attractive risk-adjusted returns and relatively stable supply-demand fundamentals.

During the recession, the dramatic cutback in employment was felt particularly hard on the office sector, with companies cutting back and focusing on essential business operations. Over the past several quarters, demand for office space has been at a cyclical bottom. While there is no evidence of a major rebound in office demand, there are some signs that the spatial market may have bottomed out.

While still moderate compared to what might be expected in a full-scale recovery, the drivers of demand for commercial property are gathering strength. Prospects look especially bright for office-using employment, which drives demand for office space. Nationwide, office jobs are expected to increase over 2% in 2011 and improve even more in 2012, before falling back in line with prerecession levels of growth. In the absence of new construction, which is off the table in most markets, moderate but steady increase in office jobs should translate to lower vacancy rates.

The office sector will still face headwinds that must be overcome before rents start increasing. The good news is that some owners are beginning to draw the line with tenants, placing a floor on rents, and are willing to face the prospects of higher vacancy rather than encumbering space with dilutive rent renewals. Unfortunately, many cash-strapped owners facing the prospects of refinancing will not have the luxury of just saying no, creating a market in which rents and occupancy rates will diverge, with the better properties moving away from the pack and distressed properties—or assets controlled by distressed owners—falling behind the curve.

With respect to transactions, the volume of office sales more than doubled in 2010, although activity was still below the market peak of several years ago.

Office capitalization rates have remained relatively high with the exception of prime office buildings, which have experienced a dramatic decline in rates.

On the performance front, office real estate investment trusts (REITs) provided a total return in 2010 of 18%, which was down from the prior year when returns were almost double that figure pushing 36%. This year-to-year shifting in performance was the opposite on the private front in which the NCREIF office returns for 2010 were pushing 12% after returns of -19% the prior year, which was the result of a combination of relatively low income returns and a staggering 24% loss in value. In terms of subtypes, the central business district (CBD) office component of the NCREIF Index had total returns in the 16% plus range, almost double that of suburban office properties. (Interestingly, suburban office properties had higher implicit capitalization rates, which may be due in part to lower barriers to entry and higher perceived risk.) Central business district returns reinforce the flight to quality phenomenon and the emphasis on top-tier properties. This is further evidenced by the appreciation rates, which only trailed urban high-rise apartments–another property type benefiting from emphasis on urban core markets.

Despite the year-to-year differences in performance between public and private markets, both enjoyed positive office returns in 2010. Whether that performance continues this year depends on a combination of improved spatial and investor demand. It also depends on the quality of assets that come to market and level of distress in the market, which will affect transaction prices and, by extension, the appraised values of the bulk of existing office assets.

Retail Market

The increase in holiday sales was welcome relief for the retail sector, which bore the brunt of the recession. Retail market fundamentals have stabilized in a number of markets, benefiting from a lack of new supply and moderate increases in demand. Interestingly, the curtailment of new construction has created challenges for some retailers seeking to increase outlets in anticipation of the economic recovery. Over the next 12 months, increasing tenant demand for locations in strong malls and shopping centers is expected to help stimulate the market. Tenants will remain selective, however, and seek locations that can be revenue positive.

While the retail sector has not turned into a seller's market, well-located projects with strong tenant bases and trade-area demographics will have an edge and enjoy some insulation from competition while construction activity remains stagnant. These centers will also benefit from tenant efforts to upgrade space and take advantage of attractive rental rates ahead of the economic recovery.

Retail property transaction volume increased in the second half of 2010. Interest was particularly strong for core grocery-anchored centers. Indeed, strong investor demand for top-tier product in this segment put downward pressure on capitalization rates, which seemed to spill over somewhat to the next tranche of properties. The willingness of investors to ante up a bit more for such assets, combined with more realistic seller expectations, closed the bid-ask spread and led to a surge in transaction volume. The change in volume was particularly well received by those holding noncore properties that have upside potential, a sector that had been fallow for several years.

While some buyers have been willing to move out on the risk spectrum in anticipation of a recovery in the retail sector, lenders have been reluctant to move down the food chain. However, well-capitalized buyers with strong credit ratings, a willingness to leave significant equity in the deal, and a track record for turning properties around have been able to access debt at attractive rates. The future is still uncertain with respect to distressed assets and core assets that are in need of capital expenditures after transfer. Owners seeking to recapture some unrealized losses will continue to hold on in hopes of a more general recovery that can help support values.

With respect to investment performance, the retail sector racked up a relatively strong performance during 2010. On the public side, freestanding retail properties outperformed other property types and led all REIT categories in terms of dividend payout, which is consistent with their bond-like lease structures. Despite this performance advantage, the relatively small market capitalization of this segment muted its impact on overall retail performance. Regional mall returns also were very strong in 2010, although the total returns of over 35% for the year were markedly below the 2009 returns, which exceeded 62%. The commodity or general-type shopping centers returns were more moderate than other retail segments, with returns slightly over 30%, which is still a strong recovery from the moderately negative returns in 2009.

On the private side of the market, retail performance was slightly over 12.5%, which was due to strong appreciation on top of moderate implicit capitalization rates. With respect to retail subtypes, the experience on the private side differed from the previously mentioned public side. Private-side regional and super-regional malls led the pack with returns in the mid-teens and freestanding properties lagging.

Despite the surge in retail sales at the top-end of the market, fashion- and specialty-center performance lagged due in part to the increase in supply in the upscale, lifestyle segment of this sector. Going forward, limited construction and improved demand from retailers should generate competitive returns for the sector. However, these returns will not span the entire retail spectrum, with weaker properties in poor locations struggling with few prospects for revitalization.

Apartment Market

The apartment market has become the poster child for the commercial real estate market recovery, coming in at the top of the list in most polls. Apartment fundamentals have indeed improved, with vacancy rates beginning to trend downward and demand poised to increase.

Apartment market demand is being driven by a number of demographic trends related to age and lifestyle preferences. As the economy begins to pick up momentum, household formations should also increase as adult children leave home. Also, the pace of condo-to-apartment conversions is tapering off in many markets, putting downward pressure on the recent surge in apartment supply.

The condo market is far from recovering, and some owners and lenders of stalled projects have turned toward auctions to move product; this trend has been somewhat successful. Auctioned properties have often traded at deep discounts in recent sales, but lenders and distressed owners have shifted their focus from saving face to clearing out the backlog of product. This trend has been led, in part, by the reality facing the industry and the spate of foreclosed and distressed properties still in the queue that will further depress prices. It also reflects recognition of the management- and capital-intensive nature of managing distressed apartment projects, which makes the option of waiting to recoup investment less attractive to owners.

During 2010, apartments generated compelling number in the public sector, with apartment REITs producing total returns over 47% for the year as a whole. This came on the heels of 2009 returns exceeding 30%, which also led all major property types. The road to performance on the private side revealed a similar, albeit less dramatic story. For 2010, apartments led all property types in the NCREIF Index, with total returns over 18% due to strong appreciation and modest income returns. In terms of subtypes, urban high-rise projects racked up total returns pushing 20%, which was slightly behind low-rise apartments, which have a total market capitalization of less than half that of high-rise properties.

Herd behavior often characterizes the institutional real estate market during periods of distress. Evidence of this behavior has been seen with urban infill projects, which have had the lowest implicit capitalization rate, both in relative and historical terms. Support for these projects reflects strong investor demand and buy-in of the trend toward urban living. The end result is a demand-driven improvement in spatial market fundamentals that may be overwhelmed by a surge in supply as apartment developers respond to strong investor demand and ready lenders but ignore supply and demand fundamentals. New product is likely to be concentrated at the top end of the market, generating core trophy properties in demand by institutional investors and lenders. Unfortunately, this segment is rather limited with respect to the broader market and thus, more prone to oversupply than the market as a whole. Therefore, while apartments may remain the darling of the industry over the near term, there is some downside risk in terms of supply and demand fundamentals.

Industrial and Distribution Market

The industrial and distribution market is more closely tied to the economic cycle than other property types due to its strong dependence on the manufacturing and wholesale sectors. After struggling with rising vacancy rates (which to some are stated as occupancy rates in a glass half-full mentality), vacancies have started tapering off. This can be attributed to improvement in the manufacturing sector as well as import and export activity.

Vacancy rates are still high relative to long-term averages, but improved demand, coupled with limited additions to supply bode well for the property sector. Indeed, net absorptions for industrial and distribution space in 2011 are projected to trend upward, building on the slight gains in 2010 and reversing the negative figure in 2009. While asking rents are still flat, the long-term, AAA nature of leases has provide some stability to pro formas and helped hold values relative to other property types.

A number of changes are on the horizon that may affect future demand for industrial and warehouse space, but they will probably not disrupt market balance since most insiders have already discounted them. For example, the impending completion of the Panama Canal expansion has been fully vetted, with shippers and developers making offensive moves to get ready for the opening in 2014. Similarly, infrastructure limitations surrounding many ports have created opportunities for secondary ports that have less capacity constraints. Changes in imports and exports with respect to products and destinations (and associated changes in supply chains) will also have an impact on demand in terms of type and location. Finally, technological innovations will continue to change emphasis from storage to throughput, triggering changes in demand for space that may leave some existing properties behind. The bottom line will be more differentiation among products in terms of fundamentals and ultimately investment performance and pricing.

With respect to performance, industrial REITs lagged other property types with total returns around 18% in 2010. Unlike other property types, the trend was upward with a significant improvement over the 12% returns for the sector in 2009. On the private front, industrial properties in the NCREIF Index lagged other property types with returns slightly over 9% for the year. However, it should be noted that industrial properties also generated the highest income returns with an implicit cap rate around 7.25% and modest appreciation. At a sub-property type level, the "crossroads of commoditization" may have already been passed, as evidenced by the significant differences among sectors of the market. For example, industrial research and development properties generated the highest returns, almost 12%, reflecting interest in biotech and specialized production facilities. On the other hand, industrial-flex space, which often has weaker fundamentals in terms of competition, provided the lowest returns including moderate losses in value. Industrial warehouse properties, which account for the lion's share of industrial space, pushed 10% returns.

Going forward, the industrial sector is expected to benefit from the economic recovery ahead of other property types. This will dampen some of the downside risk the sector faces due to the continued disconnect between the capital and spatial markets and may allow it to reconnect ahead of the curve. Unfortunately, with all the interest in apartments and urban projects in general, the industrial route may be the road less taken.

Real Estate and Capital Markets

Real Estate Capital Markets

After several disappointing years, real estate transaction activity began to pick up in the second half of 2010. Despite this increase in activity, buyers remained very selective and focused largely on top-tier core assets. This drove up prices and created a capital divide between the haves and have-nots with respect to investors' sweet spots.

In terms of players, equity capital flows to real estate have been led by REITs, both public and nonlisted REITs. The increase in the number of distressed-property workouts suggests that opportunistic investors are also stepping up to the plate, although such activity is largely under the radar. Symptomatic of the times, lenders have also been active, but they are reluctant buyers of distressed properties. Some users have taken advantage of the dip in values and a shortage of investors for main-street properties by acquiring real estate for their own use. This trend may also be partly related to the impending FASB 13 lease modifications. FASB 13 will require corporate tenants to disclose the present value of lease obligations on their balance sheets in an effort to provide more transparency and a more accurate picture of assets and liabilities. Institutional investors have been something of a wash in terms of net capital flows, with value losses more than offsetting the tepid pace of acquisitions.

Further improvement in the stock market may reduce real estate exposures below target allocations. If this occurs, institutional investors are likely to continue to focus on core assets although the definition of core will be expanded beyond the narrow range of trophy assets that have garnered the most attention to date. Private capital sources and offshore investors also are likely to step into the market. Finally, established opportunity funds that have survived the downturn, have cash, and have access to capital through investors and lenders will also ramp up activity, focusing on distressed assets that the broader market will continue to eschew. Indeed, some of the funds that turned away investors whose return requirements were too high are now likely to open the doors and proclaim they have finally found the road to success. The reality is, of course, that the destination has moved closer, with an increasing number of owners willing or forced to take the hit and move distressed assets off the books.

Mortgage Market

As with the spatial and equity markets, the mortgage market will exhibit more divergence going forward.

Borrowers with solid credit and top-tier properties will be able to access plentiful, cheap debt capital. For example, some borrowers on both the public and private side of the industry have been able to get quotes for longer-term debt with spreads over ten-year Treasuries in the 200 basis point range, translating to fully loaded mortgage costs under 5%. For REITs, the cost of capital is below dividend rates, creating an accretive window where the more they buy, the faster they grow stock prices. Similar terms have been offered to some of the established opportunity funds, providing them with a competitive advantage over less capitalized and less experienced players.

To this point, loan workout activity has been fairly selective, focusing on the top end of the quality spectrum in terms of assets and borrowers. Recent trends suggest lenders have accelerated the pace of loan modifications, workouts with borrowers, and dispositions to work off the backlog of problem loans. Going forward, lenders will move further down the quality spectrum, and the severity of loss will increase and recovery rates will decline relative to recent averages.

In some cases, the workouts will begin shifting from current owners, and assets will be transfered to third-party lenders. Many of the new capital providers will be opportunistic. Some will embrace a loan-to-own strategy with the intent to foreclose on the property and squeeze out the borrower at the mortgage-transfer price rather than trying to restructure the loan. For existing lenders this approach allows them to work off troubled loans without the risks associated with managing the foreclosure process themselves. It also avoids having to deal with disposition of REOs since the title is not transferred to the primary lender.

Going forward, mortgage-transfer prices are likely to face downward pressure as the value of collateral in the remaining pool of troubled mortgage declines over time. This will set the stage for some bulk mortgage sales that increase scale and provide diversification in terms of property type, location, and collateral values.

During 2011, the first wave of five-year and seven-year bullet loans (i.e., long-term amortization, short-term maturities) that originated during the peak of the market will be maturing. While some of these loans will be refinanced with borrowers staying in place, the negotiations are likely to become increasingly difficult as the loan-refinancing cycle plays out. In many cases, borrowers will have to produce additional capital to buy down outstanding mortgage balances and provide some cushion in loan-to-value ratios. In addition to real equity, borrowers may also have to put up personal pledges on at least a portion of the debt. This will cause a shakeout among players, especially those without the stomach to operate in more of an at-risk mode.

The commercial mortgage-backed securities (CMBS) industry will face its own crossroads in 2011. On the positive side, CMBS issuances are projected to increase, led by a handful of large-scale securitizations in process. If these deals do get done, new issuances will outpace the $12 billion in deals during 2010, with estimates of total CMBS potential issuances ranging from $40 to $50 billion. While this figure is welcomed news, it pales in comparison to the $235 billion record at the market peak in 2007.

While new CMBS originations are expected to continue to grow, the industry will still have to deal with the overhang of distressed assets and the record delinquency rates as maturing bullet loans come due. On a positive note, an increasing volume of troubled loans have moved out of special servicing, and the volume of loans moving into special servicing has declined modestly (although still outpacing workouts). This suggests that the industry is beginning to clean out the inventory of troubled assets and is positioning for growth as market fundamentals improve. As with the equity market, recovery rates for troubled loans will diverge and be more unstable, creating greater risk and focusing attention on market fundamentals.

Conclusion

The commercial real estate industry is clearly at a crossroads. Some suggest that the economic recovery will bolster the market and lead it back to the old norm. While the continued economic recovery will indeed ultimately help the industry, that help will be both lagged and muted by the magnitude of the headwinds the industry must overcome. Although the road ahead will be foggy and peppered with potholes, there are an increasing number of signs that spatial market fundamentals have bottomed out and are on the gradual road to recovery.

There is a real danger, however, that the real estate capital markets have gotten ahead of the spatial market recovery, with recent returns at unsustainable levels. This temporal disconnect can be attributed to a number of factors, but the most insidious is the carryover of the commoditization of real estate with a compression of performance that belies underlying market fundamentals. This has, in effect, led to the trickle down of low capitalization rates from top-end trophy deals to the broader universe.

Going forward, property sectors, markets, and submarkets are likely to face divergent paths, creating an environment in which balancing the risk-reward equation becomes paramount. This situation will in turn force greater attention on underlying real estate fundamentals. This will smooth out over the long term, but in the meantime it will create an interesting journey—one that some may opt to sit out while others discover that they should have done so too.

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