

A Long, Hot Summer and Prospects for a Frenetic Fall

by James R. DeLisle, PhD

Commentary

From a glass is half full perspective, the economic environment has shown some sign of improvement, although most of that improvement has been in a decline in the rate of deterioration. This reading is exemplified by the job market, where optimists take solace in the decline in the rate of job losses.

While there have been some glimmers of hope, economic conditions remain weak, with few prospects for a turnaround on the horizon. In this environment, survival remains the mantra for businesses, governmental agencies, and consumers. Since many have already cut the fat out of budgets to deal with declining income and dwindling reserves, the remaining options for staying afloat are painful and require even more difficult sacrifices than in the past.

On a positive note, the stock market has turned the corner from the meltdown earlier in the year, reversing some of the losses and raising hopes the market has begun to bottom out. Given the weak economic environment and the absence of an obvious economic leader, such improvement may not be sustainable. However, a flat-market outlook is better than many had predicted at this stage of the cycle.

The market has been helped in part by the stimulus packages and stabilization in the much-maligned housing market, as tax credits, low interest rates, and motivated sellers breathe some life into the sector. Despite this improvement, the industry remains on soft ground. There is additional downside risk as moratoria on foreclosures expire, and buyers struggle to gain the confidence and wherewithal to get off the fence.

The commercial real estate market continues to toil under the weight of weak fundamentals of supply and demand and tight credit markets. The

sector also faces downside risk from with the built-up stock of distressed assets still off the market and a wave of refinancing coming due. This situation should continue over the near term, with a lagged recovery being the most optimistic scenario. The good news is that the erosion in market fundamentals may have peaked; however, net income levels will be under pressure as leases expire and market rents lag contract rents.

The Economic Environment

The economic environment remained very much on everyone's minds as we entered the summer of 2009. The U.S. economy continued to struggle, although there were some signs the recession might be playing out.

The banking industry survived the recent stress tests, suggesting that the industry may be able to avoid further deterioration. However, the results of the stress tests also revealed a number of problems that must be resolved before the industry can resume operations at the levels needed to restore stable credit markets. Interestingly, rather than focusing on credit flows, the major banks seem to be concentrating on getting out from under the Federal Reserve's hand. Indeed, of the ten banks that received financial injections under the Troubled Asset Relief Program (TARP) last fall, nine have announced that they have bought back the preferred shares issued as collateral for the bailout funds. While this could be taken as a positive sign, in a number of cases the underlying motivation was banks' desire to get out from under the onerous government regulations and executive compensation limits that had been imposed.

The banking industry received a major blow when Standard & Poor's downgraded ratings for eighteen U.S. banks, which pushed five bank's issues

into junk-bond territory. This widespread downgrade had been rumored for some time, reflecting rising concerns over the risk profile of financial institutions and growing recognition that the industry would have to make significant changes. While banks try to shed balance-sheet risk, many continue to carry toxic assets that are likely to be problematic going forward, especially if the recovery stumbles. The Obama administration's extensive plan to revamp financial regulation will be closely watched as it extends efforts to return stability and regain confidence in the beleaguered sector.

The administration also seeks to extend its reach to the derivative and credit swap industries to help rein in the industry and avoid further financial meltdowns. While fraud prevention is one of the stated objectives of this initiative, the changes are also designed to restrict activities that pose an unacceptable risk to the financial system. The proposed changes are also designed to promote efficiency and transparency to protect unwary investors and the public at large from further scandals. Given the global nature of the problem, similar efforts are expected in other countries as evidenced by the announced regulatory crackdown on banks in the United Kingdom. The pressure on banks to improve governance and maintain adequate reserves in the United Kingdom has global implications and could reverse some of its draw for global banking activity.

The Obama administration also has turned its attention to the insurance industry and is proposing a new office to develop policies for the currently state-regulated industry. While federal oversight would signal a major change, it does not go as far as wanted by some large insurers. Large insurers have argued that federal oversight would lead to more standardized regulations than the state-based system. As might be expected, this proposal has triggered arguments among those with competing business interests. Given the stakes, the debate around insurance industry regulation is likely to be heated.

Other industries, business practices, or factors that have the potential to disrupt the economy or capital markets also are likely to come under increased federal scrutiny. This implicit pressure is liable to inhibit creativity and preempt the introduction of some potentially riskier private-sector initiatives that could help jump-start the recovery. The Administration will move carefully before taking on more battles, however, in the face of rising public concern

over the growing deficit and the spate of economic interventions, some of which have met with limited success. This reluctance to enter new economic areas is especially true in light of the administration's aggressive agenda on such hot-potato issues as health care reform and energy regulation.

Although there are signs the economy is beginning to turn around, the recent decline in industrial production is a reminder that we are not out of the woods yet. Indeed, the near-term prospects for a significant recovery are cloudy, suggesting we are going into a long, hot summer with limited tailwinds to help propel us forward. Indeed, we can expect a period of economic volatility, much like the national weather patterns, vacillating from drought to flooding. The near-term economic environment should be characterized by a bouncy ride as we approach what appears to be the bottom of the cycle. As such, conditions will be more volatile than normal, with upside potential and downside risk taking turns peeking out from behind the curtains. Thus, the stage is set for even more interesting times that are a far cry from the summer doldrums of past years.

Economic Growth

During the first quarter of 2009, annualized real gross domestic product (GDP) growth declined around 6%, which reflected a modest improvement over the disappointing 2008 fourth-quarter figures. This represents the third consecutive quarter of losses, which started in mid-2008 with a very modest decline. For the trailing twelve months, GDP fell by 2.5%, the largest decline in over twenty-five years. The contraction in GDP growth was led by significant declines in fixed investment, imports, and exports. Government expenditures were off moderately. While consumption exhibited a moderate increase over the prior quarter, it was still down relative to the trailing eight-quarter averages.

Despite disappointing figures, there is a growing perception that the economy may start turning around toward the end of the year. Some of the factors behind this expectation include a drop in inventory levels and a modest increase in consumer spending in anticipation of spending under the federal government's stimulus program. Indeed, increased expenditures for infrastructure investment already have translated into a number of road and highway projects across the country. In addition to creating much-needed jobs in the construction sector, the

increased expenditures on shovel-ready infrastructure projects will have a multiplier effect for related industries.

The dollar has remained mixed against major currencies, with the exception of the pound, which is being weighed down by concerns over the United Kingdom's economy. The current account deficit has improved, declining in absolute value and as a percent of GDP. This improvement was due in large part to a narrowing of the trade deficit to its lowest level in some ten years. This improvement bodes well for the economy and suggests economic output may be postured for some additional improvement.

On the global front, emerging markets continue to struggle, although the declines have moderated. Indeed, gains in emerging-market stock prices have outpaced those in developed countries. Similarly, spreads on emerging-market credit have narrowed, reflecting a moderate improvement in expectations.

Employment

The good news on the employment front has been the absence of major unexpected cutbacks as the pace of job losses has moderated. This slowdown in losses has been led by a number of industries, including leisure and hospitality, business services, construction, and trade/transportation. On the other hand, government employment experienced a reversal, with job losses supplanting gains in spite of the increase in temporary workers as the U.S. Census Bureau gears up for the 2010 census.

Despite the slowing of job losses, for the ranks of the unemployed there is little to cheer about with new hiring activity trending downward. Indeed, companies continue to pare back on employment as they tighten their belts. Some sectors and regions are being particularly hard hit by the ripple effects of the near collapse of the automobile industry and the continued weakness in consumer sales.

With respect to separations (voluntary, involuntary, and retirement), the pace has declined over the past year as employees hang on to jobs and older workers forgo retirement in hopes of rebuilding or shoring up retirement accounts. While the pace of job losses has subsided, there are no obvious rallying points that suggest employment growth will turn around. However, some industries are benefiting from the stimulus programs as infrastructure activity picks up and federal funds are dispersed.

As expected, the unemployment rate has pushed near 10%, with some hard-hit markets well into the double-digit range. The picture is especially bleak for unskilled workers, who are being squeezed out of the market by the trickle down of displaced skilled workers and older workers who have been forced to delay retirement. On a somewhat encouraging note, continuing claims for unemployment declined in May, reversing the trend that began early in the year. This indicator has been reinforced by the slowdown in initial claims, which have continued to trend downward. Despite such improvements, additional job losses are expected with no signs that companies or government employers will begin significant hiring over the near term.

Inflation and Interest Rates

Inflation remains in check due in part to the weak economy's downward pressure on prices. This pressure has been most pronounced in the case of producer prices, which have experienced record declines. Despite the downward pressure, the risk of deflation has somewhat subsided as the economy appears to have reached a degree of stabilization.

The low level of capacity utilization and weak labor market suggest inflation is not likely to be a major concern. Gasoline prices have moved up due to seasonal increases in demand and rising crude oil prices, which have hovered around \$70 per barrel but face some upside pressure. The prospects for declining inventory levels, rising demand, and increasing prices create some inflation-related concerns. Import prices rose modestly but consistently throughout the second quarter, continuing a trend that began in March. Despite these increases, prices are significantly off the year-ago figures, reflecting the global recession and worldwide decline in consumption. Export prices have also eked up recently—although not nearly as much as import prices—but are still below last year's levels. Even with the modest gains in prices, expectations for low inflation remain fairly ingrained, as reflected in declining spreads for inflation-indexed investments. However, some attention will continue to be focused on oil and other commodity prices.

Despite considerable turmoil in the credit market, interest rates remain historically low. This situation is likely to continue over the near term as the Fed focuses monetary policy on nurturing the economy out of the doldrums. While low rates are an

important tool in helping the fledgling recovery, the level of interest rates may not be as critical as the flow of capital, which remains problematic. In fact, efforts to increase oversight of financial institutions and the broader credit market may exacerbate the problem, forcing lenders to stay on the defensive. This tendency is evidenced by bank loan officers' reports that they are tightening credit, although at a moderating rate. This situation will have to ease before the economic recovery can gain any real momentum.

On the mortgage front, the Fed has worked hard to ensure rates stay low, by pulling out all the stops to bolster confidence in the sector. The ability to hold mortgage rates down and increase access to capital will be critical to the recovery of the housing market. This will affect both the bottom end of the market as well as the upper end, which, until recently, was starved for capital after the jumbo market dried up and spreads widened.

Business Indicators

A recent decline in industrial production is symptomatic of the broader business environment, which remains relatively weak in spite of some positive signs. Business confidence levels have improved modestly, although business practices remain guarded. Inventory levels have fallen somewhat, although high ratios of inventory to shipments suggest efforts to reduce inventory levels are likely to continue to accelerate. Capacity utilization continues to fall and remains low relative to historical averages. This excess capacity will have a negative spillover effect on the real estate market when the economic engine gets back on track, and real estate is likely to underperform other asset classes due to a lagged effect.

Corporate profits improved moderately in the 2009 first quarter, reversing the decline experienced over the prior six quarters. The increase in profits was led by financial institutions, while profits for nonfinancial institutions were off; however, the recent turmoil in the financial sector is likely to eat into profit margins. A number of businesses have continued to cut prices in an effort to hold profits up. Productivity improvement has also helped on that front, as businesses have aggressively cut employment figures relative to the levels of contraction in previous recessions. The exception to improved productivity is the manufacturing sector, which has continued to trend moderately downward.

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In the current environment of uncertainty, business growth is expected to be tempered although some sectors may begin to break away from the pack, especially those in sectors targeted for stimulus funding.

Stock Market

The majority of industry sectors have experienced improving performance since March. As a result, the Dow Jones Industrial Average experienced a modest uptick, returning to levels held during the fourth quarter of 2008. The NASDAQ 100 has outperformed the Dow and remains above 2008 fourth-quarter levels. Price-earnings ratios also ticked up in March and again in June, signaling a modest rise in investor confidence. As might be expected, the stock market has remained volatile, as skittish investors react to the latest news. For example, after experiencing a modest recovery following the positive results of stress tests, bank stocks fell on the heels of news of the new regulatory plan and rating agency downgrades.

During this stage of the cycle, the market is expected to remain tenuous. Investors are paying close attention to the economic recovery and seeking opportunities for profit taking as individual stocks begin to move away from the pack. This experience is being echoed in the global markets, reflecting the widespread nature of the economic malaise. The interdependency of global economies will continue to place a drag on trade and make it a difficult environment for export-oriented economies until worldwide consumption begins to improve.

Companies are expected to stay on the defensive, with an emphasis on cost containment and balance sheets. If the economy continues to improve, some sectors are likely to begin posturing to participate in the early stages of recovery. Unfortunately, these activities will not translate to a wave of new hires or investment in new plants, especially in light of tight credit and stockholders' attitudes regarding risk.

Consumer Confidence

Consumer confidence continued to improve through May, rising to the highest level since mid-2008. This improvement is somewhat remarkable in light of record deficit spending, a wave of corporate scandals, expanded bailout efforts, continued employment losses, eroded wealth, tempered income expectations, and a languishing housing market. The improvement was attributable to gains in the “current situation” survey component, suggesting consumers are not in as bleak a position as they had been. It also appears that consumers are starting to believe the worst is behind them and that better times—or at least a slow-down in erosion—are ahead. Indeed, a rising number of consumers report an expectation of higher earnings, although the weak labor market and defensive posture of many companies belie that expectation.

Despite concern over whether consumer confidence can hold up, the news of its improvement had a positive effect on the stock market in late spring and created something of a rally. Nonetheless, confidence levels remain tenuous and are not insulated from a reversal if conditions deteriorate.

Retail Sales

Retail sales have continued to deteriorate, despite the improvement in consumer confidence levels and infusion of stimulus money. Indeed, it appears a significant number of consumers have used the infusion to help replenish depleted savings and retirement portfolios. The personal savings rate has continued its dramatic upward trend, rising to the highest level in some forty years of tracking.

While the savings rate is positive on a number of fronts, the renewed interest in savings and concern for longer-term welfare have had a negative effect on already weak retail sales. The decline in retail sales toward the end of the 2009 second quarter was particularly disappointing for those who hoped to ride on the coattails of increased consumer confidence. The prospects for sales remains guarded at best, as consumers feel the pressure of additional job losses, nonexistent raises, and a relatively flat housing market.

The decline in retail sales has created significant challenges for retailers across the board, with few segments avoiding declines. Many retailers are saddled with a significant decline in same-store sales over the prior year. The exceptions have been drug stores and discount and deep-discount retailers.

Department stores and specialty retailers continue to struggle, with the upper-end market particularly hard hit and luxury merchants reporting significant declines in sales. Sales in the beleaguered automobile industry increased significantly in May, although it took sizable discounts, easy credit, job-loss protection policies, and liquidation sales associated with the closure of dealerships to turn the tide.

In an interesting development to those who track the retail industry, Walmart and a number of other retailers have announced they are suspending monthly sales reporting. However, the lack of reporting will do little to shift attention away from current-period sales, and it may actually increase investors' angst. This could work against retailers and create lags in market reaction after retail sales eventually begin to firm up.

Currently, there are no signs that the retail industry will experience any meaningful improvement. Defensive inventory and buying strategies are being embraced by many retailers, setting the stage for difficult back-to-school and holiday sales periods.

Housing Market

The housing market continues to create a significant drag on the overall economy. The number of delinquent home loans in the 2009 first quarter reached a record level that goes back to the early 1970s. Despite the overall problem, there is evidence some of the stimulus programs and other initiatives are having a positive effect and are helping keep the industry from falling further. Indeed, housing starts have jumped up, led by an increase in the multifamily sector. Single-family starts as well as building permits also have turned up, albeit modestly.

Despite these upticks, the pace of housing construction remains significantly below that of the prior year. Home builders in many markets are offering deep discounts to clear out inventory. Their efforts have been bolstered by revisions to the initial tax credit program, which have removed some of the strings and opened the door to use of the credits at closing. The benefits for home buyers offered by these changes are being heavily promoted as real estate professionals and home builders redouble efforts to attract first-time buyers to the market.

In terms of existing owners, the housing market continues to reel from the excesses of the past, with delinquency and foreclosure rates rising to record levels in the 2009 first quarter. Although less visible,

the significant increase in short sales—in which lenders have been willing to write down loans and absorb losses—has helped avert even more foreclosures. It has also helped stimulate sales of the backlog of existing houses built up in the pipeline.

The increase in delinquency and foreclosure rates has occurred in spite of valiant efforts to intervene and encourage lenders to restructure troubled mortgages by the Obama administration's rescue plan. While these efforts have helped some homeowners, a significant number of owners have been left in the lurch. In addition to those not eligible for such assistance, many marginal owners have failed to take advantage of the opportunity in the face of the documentation, time, and effort needed to restructure loans. Furthermore, some lenders who adopted a moratorium on foreclosures have decided it is time to move on and focus on new business activity, which should lead to another wave of foreclosure activity.

Although access to low-interest financing helps alleviate short-term problems for many stressed homeowners, it also allows housing prices to plateau at levels above what market-rate financing would support. This is something of a double-edged sword in terms of impact on exit strategies and future values. Since market rates can be expected to trend upward and move toward longer-term averages, appreciation rates will face downward pressure relative to more normal times as future purchasing power is more constrained. However, when faced with the alternative of losing a house or not being able to access the ownership side of the market for the first time, many individual homeowners will not have the luxury of taking a longer-term view and are likely to jump on any source of cheap, available credit.

Despite increased activity, there are few prospects for a widespread recovery in the housing market. At the same time, in markets that avoided dramatic overbuilding and have prospects of some economic recovery, home-building activity may gradually return. However, such activity will be tempered and will depend on strong fundamentals that can withstand scrutiny of lenders and investors who will continue to be somewhat defensive.

Real Estate Market Overview

At an overall level, commercial real estate market fundamentals have continued to erode under the pressure of a weak economy, employment cutbacks,

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and tight credit that adversely affect tenants, owners, and investors. In this environment, conditions are expected to continue to erode. This situation is likely to extend beyond the economic turnaround, with many companies having significant levels of excess capacity that must be absorbed before turning to new facilities.

In addition to value declines associated with weakening fundamentals of supply and demand, the commercial market is likely to face additional losses in value in the face of rising capitalization (cap) rates and shortages of capital. These capital market forces will place significant upward pressure on yields, which will translate to even greater losses in value for properties earmarked for sale. This impact will also be felt on mark-to-market portfolios of properties, as in the case of assets in the NCREIF Index. This situation will be exacerbated by two major trends. First, the significant wave of distressed assets that have been held off the market will begin to hit the streets in the second half of 2009. Second, the initial wave of major refinancing activity needed to bail out the short-term bullet loans issued at the peak of the market will start coming due over the next two years. With few prospects for a major influx of replacement debt capital on the horizon, a growing number of owners are likely to begin shedding assets or giving the keys back to avoid foreclosures. These conditions will start emerging in the second half of 2009 and culminate in a frenetic year-end market. Unfortunately, buyers are likely to remain skittish in the face of uncertain values and are unlikely to jump in until the risk of further value losses can be quantified.

Office Market

At an aggregate level, the office market in the United States has continued to deteriorate, with vacancy rates trending upwards to the midteens. As a result of the upward trend, office vacancy rates rose to their highest level since late 2001. Central business district

(CBD) markets have fared better than suburban markets, with vacancy levels around 13% and 16%, respectively. Office absorption rates have been negative, continuing the trend that began in early 2008. The rise in vacancy rates has led to a reduction in rents and increases in incentives offered by landlords to attract and, in many cases, retain tenants. This has created challenges for capital-starved owners who have not been able to compete due to cash-flow problems and lack of access to new capital. The end result has been a drag on net operating income that has led to further declines in appraised values of mark-to-market investments.

This office market is likely to deteriorate even more in the face of softening demand due to the sluggish economy and excess capacity controlled by tenants. The situation will be exacerbated in some markets as new, speculative projects in the pipeline come on line. The good news is new projects that were not past the point of stopping have been put on hold or abandoned. Indeed, through the first half of 2009, private and public office construction activity have declined by almost a third compared to the same period in 2008.

Although there has been a significant increase in motivated sellers, office transaction levels in the first half of 2009 were abysmal, especially in light of the growing desperation of some owners facing maturing bullet loans. The decline in sales volume has been felt across the board. Cap rates have continued to trend upward, with the most dramatic rise in CBD product. Buildings with vacant space—which earlier in the cycle had been viewed by some as offering upside potential—have been particularly hard hit with limited prospects for adding to rent rolls in the face of further contraction among tenants.

As might be expected, the pipeline of deals has begun to build ahead of the surge of distressed assets. This is creating some opportunities for patient, long-term investors who can sort out the deals with good fundamentals. At the same time, the bid-ask spread is likely to experience further compression, although sellers with staying power are hanging on to assets in hopes they may catch the next wave of correction. This situation may change as new product continues to come on the market and the first wave of distressed assets begins to hit the streets. The good news is the pace of additions to the ranks of distressed assets slowed a bit early in the second quarter; however, the current total is still reportedly in the range of some \$18 billion.

Retail Market

Among the major property types, the retail sector has been under the microscope more than other property type as a result of the shakeout among tenants and the widespread decline in retail sales. While a significant shakeout has already occurred in the retail sector, the recent drop in retail sales has made it clear the industry will be under pressure for some time. Indeed, this situation is likely to prevail even after the economy begins to improve, as consumers continue to exhibit discipline and resist the urge to let rising confidence levels lead them back to the cash register.

In this environment, there is little room for tolerance for retailers with “a great brand with a lousy balance sheet,” as in the case of Eddie Bauer, which has filed Chapter 11 bankruptcy. This icon of the Northwest has some suitors who are promising to continue business as usual. While this claim may appease some, the harsh reality is the retail industry has been forced to deal with a different standard of business than in the past.

For industry veterans who have anguished about the continued expansion of retailers into an array of new products and unproven formats that seemed more driven by capital than fundamentals, this new reality is not really unexpected. Indeed, although the shakeout in the sector is likely to be painful, it may create a renewed interest in fundamental research focused on unit profitability and market sustainability, rather than market share. This may create ripple effects that continue to hit some marginal projects hard, even after the economy begins to pick up and consumers begin to address pent-up demand. This outlook will hit some of the newer, more popular formats—mixed use, lifestyle centers, transit-oriented projects, and suburban/urban renaissance retail markets—that have received the most attention among developers, retailers, and investors. While many of these projects will survive the downturn, those that have gotten ahead of the demographics will languish and struggle for tenants.

Retail vacancy rates have continued to trend upward, with some markets and segments experiencing double-digit vacancy. Negative absorption rates continue to plague some markets, cutting across retail formats, including grocery-anchored neighborhood and community centers. At the same time, asking rents have softened, creating additional downward drag on the market and forcing some owners to

acquiesce to tenant pressure to renegotiate rents on existing leases. This situation has not played out across the board, with centers in solid locations and with rosters adjusted to local demographics holding their own. However, some of these centers are struggling to fill vacant space caused by the latest wave of bankruptcies and store closures as retailers focus on profitable units and current cash flow.

Retail construction activity has ground to a halt, which is welcomed news, but offers little solace to those already dealing with the excess capacity. In terms of transactions, the retail sector has struggled as investors and lenders have pulled back. At the same time, retail distressed properties have outpaced other commercial property types, with over \$30 billion in properties hanging over the industry. Retail delinquency and foreclosure rates have also risen, creating even more pressure on the sector.

As a result of the retail market turmoil, cap rates have increased across the board, hitting regional malls and urban properties the hardest. However, the upward trend has spilled across retail formats, including net net net lease (NNN) projects, NNN drug stores, and grocery-anchored centers, many of which have held their own in terms of retail sales.

In spite of these adjustments, the retail industry remains starved for capital, with investors sitting on the sidelines waiting for prices to come in line with expectations. Given the erosion in profits that has plagued many retailers and forced them to remain on the defensive, the sector is expected to continue to struggle over the near term.

Industrial/Warehouse Market

The industrial and warehouse sectors have not escaped the plight of other commercial property types, with vacancy rates rising to the low double digits during the first half of 2009. Due to the sheer size of the industry compared to other property types, this upward trend in vacancy is somewhat remarkable and speaks to the breadth of the global slowdown.

The industrial and warehouse market continues to experience negative absorption as companies pull back in the face of weak demand on both the domestic and international fronts. Leasing activity in the first half of 2009 was off by almost a third. Lease terms and average lease sizes also declined to the lowest levels in over a decade. The situation has been particularly dire in markets dependent on the automobile industry. In some markets, landlords

have been forced to renegotiate leases and offer short terms to help tenants overcome the challenges they face from a combination of tight credit and anemic demand. Industrial completions and starts have both tapered off, although construction activity has not come to a complete stop. Indeed, warehouse completions in the first half of the year remained significantly above the same period in year-to-year comparisons despite excess capacity. The pace of new starts, however, has plummeted as the industry grapples with excess capacity.

Recent transaction volumes for industrial properties has been disappointing, with sales falling across the diverse sector. Symptomatic of the troubles in the sector, the ratio of available-to-closed properties is at a historically high level and above other property types. Interestingly, the two leading sources of transactions has consisted of sales to users and sales of long-term, triple-net, single-tenant properties with relatively low risk profiles. In the face of soft investor demand, cap rates for industrial properties have risen more dramatically than other property types, with warehouse and flex space leading the pack. The decline in transaction volume is particularly troubling in light of the buildup of distressed properties. This buildup should continue to accelerate as investors try to get a handle on where rates will settle. The volume of distressed industrial properties is likely to lag other sectors, which offers little solace to those hoping to liquidate holdings.

Apartment Market

The apartment market has undergone some turmoil, in part due to its connections to the single-family market that, during its bull phase, had cannibalized potential tenants. This linkage is likely to continue, although the two markets should separate as the single-family market recovers and single-family rental and condominium projects are reconverted to ownership structures. However, this is expected to be a prolonged process.

The good news is that although apartment fundamentals are still weakening, the pace of erosion has begun to taper off. Vacancy rates continue to rise in some markets, putting downward pressure on rents and forcing owners to offer concessions. In addition to oversupply of the total housing stock, some of the weakness in the apartment sector can be attributed to continued declines in employment, which has sapped demand. Symptomatic of the diffi-

cult times faced by the apartment sector, delinquency and foreclosure rates have both trended upward.

Apartment transaction activity has picked up a bit in the second quarter, although it is still markedly lower than longer-term averages. Despite this increase, there is a significant overhang of distressed product. Indeed, some \$18 billion worth of apartment assets are labeled as distressed, lagging only the beleaguered retail sector and outpacing the faster-moving office and hotel sectors. Capitalization rates have risen across all multifamily segments, with suburban garden apartments outpacing high-rise properties at around 7% and 6%, respectively. Despite the recent uptick, apartment cap rates remain below those of other property types; however, this situation may change as prices drop to move product.

A number of the larger apartment transactions that have occurred have benefited from capital support from Fannie Mae, a source not available to other property types. Apartment construction activity has dramatically declined, setting the stage for a gradual recovery that will lag the broader economy, although not as much as other property sectors. Once the commercial market begins trading, the apartment sector is expected to become more competitive, benefiting in part due to some of the diversification benefits the sector offers investors.

Real Estate and Capital Markets

Real Estate Capital Markets

Throughout the first half of 2009, net capital flows to real estate were abysmal. Investors have been sitting on the sidelines waiting for evidence that the bottom of the market is near and values are bottoming out. At the same time, sellers have been reluctant to drop prices to clear the market, hoping that they can hold out until the economy begins to improve and capital flows return to more normal levels. Unfortunately, in light of the continuing build-up of distressed assets across most property types and markets, owners are going to be forced to make a move. This caveat is especially true for the legions of owners sitting on ticking time bombs—bullet loans set to mature over the next two years.

The credit markets are expected to tighten even more as delinquency and foreclosure rates move upward with no relief in sight. This situation will carry through the end of this year and may not bottom out until well into 2010. By that time the economy should be on an upward path, although commercial real

estate will likely lag the recovery and be in for even more difficult times than in 2009. Unfortunately, the nation's will and ability to step in and help stimulate the commercial sector may well be tapped out by that time, forcing the industry to struggle through what looks to be a long, painful, bottoming-out period.

Private Equity Market

The private equity real estate market remains largely in check, with owners who have the ability to sit on assets holding on as the market continues to erode and fundamentals weaken even more than they have. Institutional investors with mark-to-market assets should face added stress as distressed assets hit the market and trigger an increase in write-downs. This will raise the old debates surrounding investment value that surfaced in the early 1990s, resulting in some tail dragging. The good news is that private holdings have already been marked down significantly, with value losses approaching 30% over the past six months. This will take some pressure off the private sector, although the prices at which comparable properties trade will create an additional downward drag on values.

An analysis of the financial structure of the transactions that have occurred during the latest financial crisis offers insights into the tight credit markets. For example, commercial mortgage-backed securities (CMBS) and Wall Street capital (e.g., mezzanine) have fallen off the charts, dropping from around 50% of capital to a negligible amount. On the other hand, seller financing has exhibited the opposite pattern, rising five-fold and approaching 50% of transaction prices. The market share of other capital sources has remained rather stable, although the sources of funds have shifted. The dependence on seller financing will not be sustainable in the next wave of transactions, as many distressed sellers are upside down on their holdings and have few degrees of freedom with which to support prices. Unfortunately, there is no obvious white knight to step into the void, with securitized capital struggling to reinvent itself.

In this environment, the mantra that cash is king will carry well into 2010, creating the opportunity for profit taking by those who have the financial wherewithal to allocate equity capital during this stage of the cycle. While there is significant capital on the sidelines, much of that capital will remain there until there is a better sense the market has bottomed out. Finally, the denominator effect, which kept some

larger institutional investors on the sidelines as a result of declines in the value of non-real estate holdings, is likely to come back in another format. That is, with the economy picking up, the stock market is likely to benefit early on while commercial real estate will still be on the downside.

Thus, over the near term at least, commercial real estate returns may lag other asset classes. While some will argue that real estate still offers diversification benefits, and thus should receive new capital allocations, those arguments are likely to fall on deaf ears as they did in the early 1990s.

Public Equity Market

The deterioration in real estate fundamentals has spilled over to the REIT market, creating an additional drag on prices on top of concerns regarding excess industry reliance on leverage and structured debt financing. The continuing saga surrounding the General Growth REIT is likely to hang over the industry and force hard questions as investors seek some reassurances that recurrences will not happen. The declines in the transaction market have affected REIT sales activity levels, although REITs continue to pop up on the list of top sellers. Despite the desire to move product to help shore up financials and allow self recapitalization of debt, some larger planned transactions have been postponed or pulled off the market.

At an industry level, REIT performance during the first half of 2009 pushed a 10% decline, which was disappointing but a marked improvement over the decline in 2008. Indeed, returns in May were up moderately with the residential segment leading the pack.

While some REITs will continue to struggle under the weight of leverage and declining revenues, there are no signs of a widespread collapse. Indeed, some REITs have been able to raise capital to help take advantage of opportunities that are beginning to emerge in the market. These REITs have been positioning themselves to take advantage of the incoming wave of distressed asset sales, raising over \$12 billion in capital over the past several months. This harkens back to the mid-1990s, when the REITs benefited from a collapsed commercial market, aggressively buying assets at accretive yields, with rates lower than dividend payouts.

Thus, the outlook for REITs remains somewhat guarded with weakening market fundamentals creating a downward drag on the sector. REITs are

providing some signals that the timing may be getting closer for a wave of transactions. The REIT industry will be closely watched during this stage of the cycle, with investors focusing on picking stocks rather than allocating to the broader sector.

Mortgage Market

During the first half of 2009, little changed on the mortgage front, with private lenders continuing to tighten underwriting standards and the CMBS market all but gone from the scene. Commercial mortgage defaults have hit a 17-year high, which is symptomatic of the depth of the problem facing the industry. The recent spate of downgrades by the rating agencies, which have been under increased scrutiny for their role in the financial crisis, has created additional problems for the industry. Additional downgrades are expected in light of the market fundamentals and the number of underwater assets.

The prospects for commercial debt are nothing but dire. Indeed, borrowers with good credit standing seeking to refinance seasoned properties with maturing bullet loans are likely to be left out in the cold along with weaker borrowers with problem properties. This situation has been amplified by the erosion in market fundamentals that continues to unfold as the real estate industry experiences further erosion in net operating income and higher cap rates necessary to attract the few buyers who are out there. This is especially troublesome for loans underwritten with the aggressive growth assumptions and low exit cap rates that pervaded the market during the peak of the market.

In this environment, access to credit remains problematic at best. While some of the larger banks that received bailout support in 2008 were expected to step into the void, the self-imposed pressure to repurchase preferred stock to get out from under the government's oversight has cannibalized much of that activity. Some of the smaller regional banks that were not drawn into the fray have been able to help support the market, but such activity has largely been constrained to small- to moderate-sized transactions. The industry's aggressive push on Washington, DC, to secure some funds from the Term Asset-Backed Securities Loan Facility (TALF) to help shore up the commercial mortgage market has met with some success. However, the level of support is likely to be dwarfed by the sheer volume of maturing loans and distressed assets building up

in the system. This situation is likely to hang over the commercial real estate market and add to the downside risk the industry faces.

Conclusion

The recent uptick in the economy, spring rally in the stock market, and modest improvement in consumer confidence levels have received much attention. While these and other signs suggest the economy may start to turn around, more in-depth analysis suggests we are clearly not out of the woods and are facing a prolonged recovery that is more emblematic of an extended U-shape than the hoped-for V-shape.

The good news is the global economy appears to be stabilizing as well, although most optimists are depending on a “glass is half full” view of the world to support this perspective. That is, the slowdown or deceleration of losses has been seen as a positive sign. In this environment, improvement is likely to remain tenuous and dependent on the success of stimulus programs and government cooperation to maintain low interest rates and increase access to credit.

The fact remains that the broader market is dependent on leveraging at a time when deleveraging will be problematic for many sectors. This is especially true for commercial real estate, which will face a number of headwinds. In particular, the industry will have to deal with a dramatic surge in distressed asset sales at a time when capital remains tight, especially with respect to mortgage financing. As a result, delinquency and foreclosure rates are expected to trend upward, with values declining further until buyers see evidence the market is beginning to bottom out and true values are easier to quantify.

This outlook does not suggest a slowdown in the market, but a lot of scrambling around and soul-searching as owners, buyers, and capital market players try to figure out their next move. For those

who can wait, time is on their side. Unfortunately, many will not be able to hang on and will be forced to act. Once this starts occurring, the market will be faced with a spate of opportunities. For opportunistic investors without real estate acumen, however, the glut of product will be just as overwhelming as the uncertainty regarding true values that currently plagues the industry.

The time is right to focus on real estate fundamentals: investments that will pay off on both the acquisition and disposition side of the equation. Failure to assess the underlying fundamentals of individual offerings will merely substitute players and prolong the pain. These will indeed continue to be interesting times.

James R. DeLisle, PhD, is the Runstad Professor of Real Estate and Director of Graduate Real Estate Studies at the University of Washington. Prior to his current assignment, DeLisle was the director of the Real Estate Research Center and the coordinator of the e-Commerce Program at Georgia State University.

Before returning to academia, he was an executive vice president and head of strategic planning for Lend Lease Real Estate Investments, a global company and the successor firm to Equitable Real Estate where he founded the Investment Research Department and directed it for nine years. He has published widely in academic and professional journals. DeLisle received his BBA in real estate and MS in marketing research from the University of Wisconsin. He received his PhD in real estate and urban land economics from the University of Wisconsin under his mentor, the late Dr. James A. Graaskamp, one of the leading academic proponents of applied real estate research. **Contact:**

T 206-616-2090; E-mail: jdellis@u.washington.edu

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