

No Bottom and No Net

by James R. DeLisle, PhD

Commentary

The economy has begun to show signs that it is stabilizing, with the rate of decline slowing for a number of economic indicators. Despite this improvement, significant concern remains that the recovery may falter unless the housing market and employment scene begin to show more strength. Employment is particularly important to consumers, as they remain on the sidelines and thus temper the upside potential of the economy.

We can expect significant erosion in commercial real estate values over the next twelve to eighteen months. This situation will be accelerated by two major drivers.

First, a wave of distressed commercial assets will start flooding the market, and this should continue well into 2010. These assets will come from a number of sources, including lenders trying to clear out real estate owned assets. Owners that are either upside down on values, or unwilling to face the prospects of recourse financing and real equity investment positions, will find it difficult to move in any direction. This will place downward pressure on values of nondistressed assets.

Second, a tsunami of refinancing activity will hit the market beginning in 2010, but the commercial real estate industry will not have a government safety net to fall back on. In this environment, the state of the economy will be less important to commercial real estate than the state of the capital markets, capital flows, and real estate fundamentals.

The overall economic environment will be closely watched for signs that the fledgling recovery may be stumbling. The situation is so tenuous that such a scenario is not out of the question. Thus, this column will explore the question of how things might unfold,

what to look out for, and what to do. For some, it is a matter of survival, while for others it is how to take advantage of opportunities in the market.

Commercial Real Estate Coming Attractions

During this phase of the cycle, the importance of overall real estate fundamentals; disciplined, research-based decision making; and strategic vision will become even greater. That is not to say these attributes are not always important across the real estate cycle. Rather, it is a belated recognition that the combination of surplus capital flows, lack of attention to underlying property risk, and easy and cheap credit supplanted the need for these attributes for many players.

The return to fundamentals will be healthy but painful for those committed to the commercial real estate asset class. Investors seeking opportunistic returns by buying distressed assets and merely waiting for the market to cure would be well advised to stay out of the game. The old rules have changed and the new ones have not been written yet, although we can predict that they will be infused with fundamentals. Also, possible government intervention (e.g., underwriting standards, appraisal processes, new bailout programs) will be a wild card that needs to be closely monitored.

It is worthwhile to address some of the challenges that real estate professionals, owners, and space users are likely to face in the near-to-intermediate future. The list of challenges is long, so we will focus on the challenges in which the affected parties retain some control over the outcomes through proactive efforts. These manageable challenges surround several key issues: lease negotiations, valuations, asset dispositions, acquisitions, refinancing, and general access to working capital.

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One of the challenges for landlords, tenants, and tenant representatives over the next twelve months concerns approaches toward lease renewal and/or renegotiation. Many landlords have tried to help struggling tenants through abatements and renegotiated rents. Many tenants have been forced to focus on the bottom line at an individual operating-unit level, seeking rent cuts to make units viable and considering unit closures to avoid draining the corporate budget.

Commercial lease negotiations are expected to become more difficult as the commercial real estate cycle unfolds. In particular, landlords with solid properties that previously did not worry about renewals or abandoned leases will be on the defensive as buyers of distressed assets lower costs bases and compete for tenants. At the same time, the slow and uncertain pace of the economic recovery will force corporate executives to seek ways to cut costs, with rent reductions and incentives an important part of the equation.

Many landlords will be financially stressed and not have money for generous tenant improvement allowances and relocation expenses, so rent levels and lease terms will be the two variables they will use to compete. While the resultant deterioration in net operating income will pull values down, for many this will be better than a complete meltdown as tenants move out.

On the disposition front, potential sellers will be faced with an extremely difficult market overall. The severity of their individual challenges will depend on two major factors: (1) the nature and quality of real estate to be sold, which affects demand; and (2) the driving force or urgency behind the sales decision, which will affect negotiating and staying power.

Owners of fundamentally solid properties in good markets that try to sell assets may face downside sticker shock. This will be especially true for sellers not wired into the market that may not be aware of the significant loss in value many properties have experienced.

Assets located in secondary and tertiary markets, where the pool of potential investors will be even more limited than usual, will face challenges in attracting bidders. Similarly, owners of weaker properties will be forced to compete with the flood of distressed assets coming on the market as owners and lenders begin to try to move troubled assets off their books.

Given the dramatic slowdown in activity and significant backlog of potential transactions, owners are likely to try to bundle properties into pools that can be

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sold as a portfolio. While this approach makes sense, few investors will have the infrastructure and personnel to evaluate multiproperty pools. Such evaluations will be essential, however, since some sellers are likely to bundle troubled assets with better properties.

In order to meet quotas, disposition teams are likely to pressure portfolio managers to select better assets that will stand out among all the distressed assets that will be flooding the market. Despite these efforts, many disposition programs will fall short of goals unless decision makers are willing to write down assets to values at which they will clear.

Given the absence of established players on the buyer side, sellers will have a hard time evaluating the ability of potential borrowers to close in a timely manner. Of particular concern will be managers of nondiscretionary accounts that require third-party approvals that may delay closings. With downward pressure on values expected to continue, sellers will have to make a number of difficult decisions.

Although it might appear that players on the acquisitions side of the market will have a fairly easy time in filling quotas, the sheer volume of transactions coming on the market will create challenges. Indeed, many of the players reportedly sitting on the sidelines lack the experience, market knowledge, underwriting skills, and infrastructure necessary to properly manage the risk-reward equation for commercial real estate. This is particularly true in an environment that will be frothy, making it difficult to identify and close on solid assets able to endure additional downside risk as the market seeks a bottom.

In this environment, the no-brainer commercial investing of the early 1990s will not suffice. Buyers putting assets in mark-to-market accounts will have to worry about the impact of unrecognized losses they are likely to experience on acquisitions until the market stabilizes and values start to recover. Savvy buyers will have to figure out which lenders hold the bag on distressed assets controlled by troubled sellers, and how to take maximum advantage in complex, multiparty negotiations.

“Providers of capital are expected to be extremely selective.”

Of all the challenges that the commercial real estate market faces over the next several years, the most formidable will emanate from debt considerations. This situation stems from both the supply side and the demand side of the capital market. With respect to demand, the market is expected to receive a flood of mortgage rollovers as the three- to five-year bullet loans that originated at the peak of the market begin to mature. Demand for debt capital will also come from buyers who seek to take advantage of market conditions and build portfolios. Other demand sources will come from existing owners seeking additional capital for tenant improvements, capital expenditures, and other capital requirements attendant with ownership of real estate.

On the supply side of the equation, it is clear that without some form of intervention or innovation, the capital markets will be unable to satisfy growing demand. This is especially true due to the continued shutdown of the commercial mortgage-backed securities (CMBS) market and the absence of a clear replacement. Smaller local and regional banks also face many challenges regarding existing borrowers, forcing many to the sidelines as they struggle to meet capital requirements and maintain solvency.

In this environment, financial intermediaries and other providers of capital are expected to be extremely selective and adhere to strict loan origination and underwriting standards. These standards will include higher debt-coverage ratios, lower loan-to-value ratios, enhanced and speedier enforcement of covenants, greater scrutiny of track records, recourse, and more conservative valuations.

Commercial lenders are likely to introduce a variety of financial arrangements, including equity participation in equity conversion options. In order to support prices and move product, mortgages and other forms of seller financing are also expected to be common. If the economy stumbles, however, the real estate capital markets will slow even more than in the past year.

The final coming attraction in the commercial real estate market is the distressed side of the market.

The distressed aspect of the commercial market will plague all players in the market: those holding such assets, those relying on contingent collateral claims against them, and those trying to figure out how to take advantage of the imminent surge of transaction activity. Fundamental decisions will explore whether the distress is curable through proactive measures, whether it will be cured with the passage of time, or whether it reflects permanent impairment. To answer such questions, attention will focus on understanding the source of the distress.

Although individual decisions will be based on detailed analysis of properties or portfolios, the starting point will be classifying the nature of the distress. If the distress is due to a weakness in fundamentals such that a property cannot compete, then walking away or staying away may be appropriate courses of action. If the distress comes from borrower stress associated with reliance on financial engineering that eats into cash flows or requires refinancing to retire a bullet loan, the options are narrower. The selected course of action may include a sale (perhaps a short sale) with seller-assisted financing, or, absent a buyer, a voluntary conveyance or an outright foreclosure.

If the distress comes from the market erosion in net income due to oversupply or tenant cannibalization, the action plan may depend on the staying power and perseverance of the owner. Owners who are financially stressed may opt to walk, while those in mark-to-market accounts who can hang on may opt to cut their losses and dispose of assets at discounted prices.

Clearly, understanding the what, why, and who in commercial real estate will be important in navigating these turbulent times. That said, a lot will still depend on how the overall economy unfolds.

The Economic Environment

A number of economic indicators turned up in the summer, suggesting that the worst of the recession is over. However, it is noteworthy that the measure of improvement for many indicators has been a slowing in the rate of loss rather than positive growth. Thus, the near-term outlook remains guarded with hopes that the economic recovery will be enduring.

Concern over the recovery's sustainability stems from the government's stimulus and bailout programs, which are running out of resources. These programs have provided much-needed respites from the relentless downward drag of the past years. For example,

the successful Car Allowance Rebate System (better known as the cash for clunkers program) helped the automobile industry avoid a complete collapse, and the infusions of cash helped get the credit markets back on track.

On the global front, the Group of 20 economic summit in Pittsburgh focused on achieving a commitment between the United States, Europe, and China to adopt national economic policies that would produce sustainable growth to help the world recover from the worst recession in decades. Coming out of the meetings, it was decided that the agreements would be voluntary; however, the importance of the summit points to the increasingly global nature of economic activity, capital flows, and ultimately, real estate market fundamentals.

If such efforts continue, there is some hope the global recession may be winding down. If the recent trend does indeed hold, it will have a synergistic effect that will help sustain the fledgling recovery in individual countries as well as the broader global economy. Conversely, if the global situation deteriorates due to lack of consistent and widespread efforts to nurse the economic recovery, the economies of the United States and other nations will be exposed to downside risk they can ill afford.

Economic Growth

A number of economic indicators suggest the economy has bottomed out and turned down the long road to recovery. At this point, it appears the aggressive stimulus programs succeeded in preventing the economy from slipping into an even greater recession.

The drivers of the decrease in gross domestic product (GDP) growth included federal, state, and local spending, and a decline in imports. The major drags on the economy also include private inventory investment, nonresidential fixed investment, personal consumption expenditures, residential fixed investment, and exports.

It should be noted that the rate of downward pressure by these forces materially slowed beginning in the second quarter. As mentioned earlier, the cash for clunkers program also helped the automobile industry, providing a minor boost for GDP. Despite this, consumer spending remains weak as the labor market struggles. Weak consumer spending is expected to continue until the economic recovery becomes more visible to consumers, and they start benefiting from positive spillover effects.

Employment

The employment situation has shown some improvement as the rate of decline in jobs and unemployment growth have both tapered off a bit. This deceleration has been good news at a macro level, although the country still lost over 200,000 jobs in August and the unemployment rate continued to push the 10% threshold.

While the unemployment slowdown bodes well for the economy, it does not provide much solace to the some 7.4 million workers who have lost their jobs since the recession started in December 2007. Continued job losses have hit a number of industries, including construction, with a shift from residential losses to nonresidential and heavy construction. Manufacturing employment also has continued to slip, although the pace of losses has slowed down. The exceptions to new job losses have been the retail sector, which has already contracted, and the health care sector. The civilian labor force participation rate held at 65.5, while the employment/population ratio continued to trend downward.

In addition to outright unemployment figures, a significant pool of talent can be classified as underemployed. Also, as might be expected, the number of discouraged workers dropping out of the job hunt has continued to rise, more than doubling in the past twelve months. Thus, despite some positive economic news, employment has demonstrated no measurable improvement. The positive news has been that losses may be tapering off, average workweeks are being held, and earnings are up modestly.

Inflation and Interest Rates

The Federal Reserve (Fed) is holding the line on low interest rates. However, Fed officials are beginning to explore how the inevitable increase in rates will unfold. Some observers have suggested that when rates start increasing, the pace could be greater than the gradual change of past post-recessionary periods. That is, if the economic recovery surprises on the upside or inflationary pressures begin to build, interest rates may increase both sooner and faster than generally anticipated. Still, the Fed has signaled it has no intention of raising target rates in the foreseeable future, with the state of the economy the critical factor.

In a recent statement, the Fed hinted that it was well aware of the arguments against its position that the significant slack or excess capacity in the system would forestall a round of inflation. At the

same time, it revealed its recognition that some of the behavioral elements that can significantly affect reality might be played out in the current market. In particular, it suggested that longer-term inflation expectations should remain stable, opening the door to those arguing that the markets' expectations or anticipations can actually translate to reality and must be closely monitored if not directly addressed.

Based in part on its recognition of the importance of reestablishing confidence in the credit markets, the Fed announced it would purchase up to \$1.25 trillion of residential agency mortgage-backed securities and another \$200 billion of agency (i.e., Fannie Mae, Freddie Mac, Ginnie Mae) debt. It plans to accelerate this action over the near term to help jump start the market and then gradually phase back.

On the commercial front, the Fed announced it would extend the Term Asset-Backed Securities Loan Facility (TALF) by which it authorized purchase of CMBS in the spring. The new deadlines are the end of the first quarter in 2010 for existing or legacy CMBS and the end of the second quarter for newly issued CMBS. This should help dampen a surge in spreads that might have occurred, although not for lower-rated pools. The TALF is prioritizing existing CMBS loans to avoid lower-rated pools. The loans also must satisfy other certain criteria, including AAA ratings or the equivalent from approved rating agencies. Since private lenders are expected to focus on quality commercial mortgages as well, the market will be bifurcated with higher spreads between the strong and moderate-to-weak assets, with the latter largely left out in the cold. Credit flows will continue to be constrained over the intermediate term if not longer, while underwriting standards will be even tighter than they have been.

Business Indicators

One sign of good news for the stock market and companies in general is that corporate profits are relatively healthy. This turnaround is significant, but it should be noted the achievement is on the expense side of the ledger, which includes labor and investment, rather than the income side of the ledger. Regardless of the reason, the stock market and business sentiment have benefited from the situation.

Improved business sentiment has been supported by a three-month upward trend in leading indicators, with positive trends in seven of the ten components. The recent burn-off in inventory levels suggests that a moderate increase in industrial production might be on the horizon. Despite the positive news, businesses will remain cautious until they can determine if the improvement in the economy is sustainable or if it is dependent on stimulus activity.

Stock Market

The Dow Jones Industrial Average has generally trended upward since it bottomed out at the end of the 2009 first quarter, with a slight pause in June. The index almost got back to par from its trough, winding up at 86% of one year ago, providing much solace to those fretting over the devastation of their investment and retirement plans.

The NASDAQ Composite Index exhibited a similar pattern, but fared better over the same period, winding up at 95% of its starting point. Assuming the recent trends hold, the economy begins a gradual increase, and the credit markets can be restored, the austerity programs many companies embraced may position them for a rebound that leads the overall economic recovery. Anecdotal evidence of this potential is offered in the initial public offering (IPO) market, which recently saw five companies go public, the largest weekly IPO level in over eighteen months.

Despite this increase in activity, two of the five indexes closed below their initial pricing, suggesting investors will remain picky and there will be no groundswell that pulls stocks up across the board. As should be the case, fundamentals and prospects for growth will remain important differentiators. In addition, a number of technology companies are reporting increased interest in spending to benefit from new features in products like Microsoft's Windows 7 and others with added functionality.

Despite the desire to see a rebound in a critical industry such as technology, a number of observers remain cautious and worry about prices getting ahead of the market. Thus, the somewhat tentative nature of the economic recovery and lack of clear leadership other than that provided by the federal government will cause investors to remain hopeful but appropriately skittish.

Consumer Confidence

As might be expected, the continued loss in jobs, rising unemployment rates, tepid housing market, and lack of cash weighed heavily on consumers. However, after a brief setback in early summer, consumer confidence levels have once again trended upward. The improvement was led by the expectations component, as consumers began to believe that the stimulus programs might be sufficient to help maintain the recovery.

Consumers' short-term outlook improved markedly in month-to-month comparisons, while the percent holding a negative view declined. Part of the improvement in expectations was related to a belief that the employment market is stabilizing and job losses will start being reversed in the not-too-distant future.

Despite the recent improvement, there is little to suggest that the moderate recovery in consumer sentiment can withstand much in the line of disappointing news. Thus, the indicators of consumer attitudes and expectations will bear close monitoring until the eventual recovery shows signs of being able to withstand shocks. However, the moderate pace of economic recovery will not lead to a surge in confidence levels.

Retail Sales

Compared to other sectors, the retail industry has been the hardest hit by the recession as consumers have been forced to the sidelines. Indeed, even before the recession formally started, declining sales caught many retailers and suppliers off guard, forcing them to curtail operations and pull back on inventory and investment activity.

There are few signs that this situation will be reversed in the near term, regardless of the moderate improvement in consumer confidence levels. Consumers' ability to make purchases has been compromised by the declining value of savings and investment plans, erosion in housing values, tightened credit, and general lack of liquidity.

That said, retail sales exhibited their highest rebound in August, led in part by the automobile industry's cash for clunkers program. Even when isolating automobile sales, overall purchases were up and outperformed expectations. Although year-over comparisons remain on a downward trend, as with many other indicators the rate of decline has slowed, providing further evidence the recession might be behind us. In the fall, attention will focus on whether the trend will continue. Given the tenuous nature of

the recovery and concerns hanging over consumers, it will take several months to determine if the fairly widespread improvement will be enough to help propel retail out of the doldrums.

Retailers will continue to take out all stops to lure shoppers back to the registers, setting the stage for a very promotional holiday season. Unfortunately, this approach has become the norm, raising challenges for the industry going forward as a change in expectations will be critical for a real turnaround for the beleaguered sector.

Housing Market

Going into the fall, the housing market continued to show some signs of improvement with the inventory of new homes continuing to fall as sales rose to the highest level in over a year. Given the role the sector played in triggering the recession, the trend was closely monitored and had positive spillover effects on the broader market and home-builder confidence.

Despite the good news, the nagging question of whether the early recovery would continue has been much debated. There has been concern about the expiration of the first-time home-buyer program and its role in the housing recovery. This concern was heightened by the stumble in sales of existing houses in August. While the retrenchment was worse than expected, the level of existing home sales was still at its highest since the market peak in mid-2007.

The August dip in sales was echoed by a decline in median sale prices. Part of this decline was attributable to the beginning crest of distressed sales as foreclosed properties continued to make their way to the market. In spite of this new source of product, the inventory of homes to be sold continued to decline, falling to half of the level of a year ago. At the same time, the percentage of completed new homes has remained high, which is a stark reminder of the heady days in which buyers snapped up homes before completion.

The recent setbacks for the housing sector will be closely monitored to see if these reflect a temporary pause or suggest more difficulty for the beleaguered sector. However, the prospects for continued low mortgage rates and a gradually improving economy help bolster the sense of guarded optimism for the sector.

Real Estate Outlook

Office Market

The struggling economy and the lagged spillover to the office market have created a number of problems

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for the office property sector. Office returns in the NCREIF Property Index have fallen over 30%, with additional losses expected for the balance of the 2009. On the public front, office sector real estate investment trusts (REITs) have staged a dramatic comeback, with total returns through August 2009 slightly over 18%.

In terms of market fundamentals, office vacancy rates continued to climb through the third quarter, pushing 17% overall. Vacancy rates were higher in the suburbs than downtown markets due to lagged construction completions that were still coming online in some markets.

The construction pipeline has been dramatically curtailed, with a number of projects remaining abandoned and others mothballed. This trend was bolstered by increasingly negative absorption rates as tenants pulled back and rationalized space in light of the economic recession. This situation would have been worse if not for staggered leases that prevented many companies from contracting more quickly.

As might be expected, subletting activity has continued to rise, albeit at a slower pace than earlier in the cycle, as tenants lay off excess space. The slowdown in the pace of tenant contraction has been attributed, in part, to improving economic conditions, as well as the earlier surge in subletting activity when business confidence was at a cyclical low. In the current market, and for the foreseeable future, the balance of power has clearly shifted to tenants, forcing owners to focus on tenant retention and blend-and-extend lease renewals.

With the expected surge in distressed asset sales, there will be more downward pressure on office rents as buyers compete for tenants. Due to lags between office markets and the economy, and the rising swell of excess capacity, this weakness is expected to continue well into 2010 if not into 2011, depending on the speed and strength of the recovery.

Retail Market

Over the past year, the retail sector has faced one of the most difficult periods in its modern history. This situation was not unexpected, as the sector was hit hard at the beginning of the recession when consumers reined in spending after a prolonged period of overexuber-

ance. Indeed, the cutback in consumer sales was one of the major factors that fueled the broader recession.

In terms of investment performance, the retail sector experienced declining numbers in advance of other property sectors. Interestingly, retail returns in the NCREIF Property Index fared better than the office sector, with trailing one-year returns through mid-2009 falling a relatively modest 18% from the 2007 peak.

On the public side, retail REIT returns were up a modest 10% on the year-to-date basis through August. In terms of subsectors, the greatest turnaround was in the regional mall subsector, with returns up over 20%.

The retail sector has felt the full brunt of the recession. Indeed, even after several years of competing for more value-conscious consumers, many retailers have been left with cash register drawers seemingly frozen shut. For owners of retail properties, the good news is that many retailers have rationalized their operations and shed underperforming outlets, setting the stage for some expansion when the sector begins to pick up. At the same time, construction activity has been ratcheted down, helping avoid a further implosion of the sector. Given the expectations for a gradual economic recovery coupled with excess capacity and a troubled job market, prospects for growth in retail sales and improved performance in the property sector are likely to be tempered well into 2010, if not beyond.

Industrial/Warehouse Market

Through the third quarter, the industrial and warehouse markets continued to struggle as a result of the U.S. and global recession. The challenges that face the sector are creating unusual pressures on investment performance, transaction volume, and prices. Indeed, for the twelve months ending in June, the 25% loss in value in the NCREIF industrial subindex was the greatest annualized total since the inception of the index in 1978.

Despite earlier losses, the industrial sector is the only property type other than self-storage to have negative returns in the year-to-date through August 2009. In a demonstration of the fledgling global recovery and the speed of adjustment in the public arena, industrial REIT returns in August bounced back and led all property types.

In terms of industrial market fundamentals, vacancy rates have continued to trend upward, reaching unparalleled levels. Given the relative stability of the

sector as a safe haven for institutional capital, the newfound volatility has caught many investors off guard. However, this is a testament to the growing complexity of the logistics and manufacturing sectors that have steadily become more globalized.

The dramatic and somewhat unexpected plight of the industrial sector is evidenced by the fact that the increase in vacancy rates has reached record levels. At the same time, net absorption continues to be negative, setting the stage for more losses and rising vacancies. Indeed, tenants have been walking away from leases at a record pace, especially in markets affected by the contraction in the automobile industry.

As a result, rental levels have fallen, with few markets escaping the downward drag of an oversaturated market. The industry has responded with a dramatic decline in construction. Given the excess capacity in the system, the outlook for industrial property remains guarded, with the fate of the sector depending on the global economic recovery.

Apartment Market

The apartment market has struggled along with other property types, with investors receiving disappointing results. Weak performance in the apartment market caught some players off guard. They had thought the turmoil in the single-family and condominium ownership market would have positive spillover effects for rental properties.

Unfortunately, this scenario did not play out for private institutional owners, with apartment returns for the twelve months ending June 30 racking up losses near 30%—an all-time record low for private investments. On the REIT front, apartment REITs eked out a modest 5% plus return for the year-to-date through August. This followed a loss in 2008 of 25%, suggesting securitized apartment investments did benefit somewhat from the turmoil in the homeownership markets.

With respect to market fundamentals, the apartment sector has come under growing pressure in 2009, with vacancy rates rising above 7%. Although disappointing relative to historical figures, apartment vacancy rates remain lower than those of other property sectors. That said, the vacancy rate for the apartment sector was still the highest rate since the turmoil earlier in the decade.

The apartment market situation is expected to deteriorate more as projects in the pipeline come online. Rising inventory levels are creating con-

cern, especially as failed condominium projects are converted to rentals or dumped through auctions at significant discounts. As a result, both the asking and effective rents have slipped, with concessions rising as managers compete for tenants. Given the fledgling nature of the economic recovery and excess capacity in the apartment sector, the outlook is guarded with more downside risk on the horizon.

Real Estate and Capital Markets

Capital Market Overview

The fairly widespread downward pressure on real estate fundamentals and the prospects for further erosion in values have set the stage for what could become a capital crisis for the industry. This will impact both the equity and debt sides of the market.

On the equity side, weakness in trailing returns coupled with the prospects for additional losses in value will force many investors to step back and revise their real estate allocations. This tendency will be particularly pronounced in the pension fund arena and segments of the market in which mark-to-market rules apply.

This conclusion is based on the experience of the late 1980s and early 1990s, and on recent failures in the market to fully consider the risk side of the equation. Recovery in real estate fundamentals—once the elusive bottom has been reached—will lag that of other asset classes, putting real estate at a competitive advantage in terms of asset allocation.

On the debt side of the market, the situation is more troubling, with well over \$200 billion of commercial debt coming due over the next twelve to thirty-six months. This surge in refinancing, and the challenges faced by those forced to seek replacement capital due to maturing bullet loans, will be experienced on both the private and public (i.e., securitized) side of the market.

On the private mortgage front, borrowers will face a pool of lenders who may be ultimately conservative, focusing on the best assets in the best markets with the best borrowers, with tightened underwriting standards, real equity requirements, and recourse thrown into the equation where possible. Owners and borrowers not fitting that profile will face greater spreads, shorter terms, and potential equity kickers. Unfortunately, even under these conditions, access to private debt will be an elusive goal for many. Purchase money mortgages and other forms of seller financing will become an important

component in filling some of the void and helping prop up prices.

On the public side of the equation, the situation is more dire, with little respite in sight. Over the past eighteen months, the percentage of CMBS loans more than thirty days past due has skyrocketed, reaching levels never seen for the relatively young industry. Since these problem loans are not concentrated in one or two pools, the problem is much greater, with many pools containing problem loans.

At the same time, some of those pools have weaker asset mixes than others, making it difficult to assess the relative risk. The rating agencies have redoubled efforts to properly assess the risk of existing pools, focusing greater scrutiny on the mix and problem properties. As a result, credit downgrades are becoming more common, with the prospects for further erosion in credit quality. With more downside risk on the horizon, solutions for the CMBS crisis are limited unless major changes are made.

To understand some of the unique challenges facing securitized mortgage debt, it is important to recognize the factors that drove the industry to the recent heights from which it is now falling. In particular, the diversification offered in many pools was one of the attractive elements of CBMS investments, and helped attract a surge in capital to the sector. The cross-collateralized nature of assets in most pools, assuming a generally high quality of assets, created an investment in which the whole became more than the sum of its parts. Thus, if properly constructed, the diversification of the pool could help increase risk-adjusted returns by reducing portfolio-level risk. The end result was more competitive prices due to lower spreads than comparable risk assets that did not benefit from such synergy.

The downside of the assemblage and interwoven structure of assets is that unraveling a CMBS or pulling out individual properties (through sale or foreclosure) can have ripple effects that disrupt the harmony of the residual pool. To manage that risk, mortgage contracts and collateral pledges for CMBS loans have placed restrictions on what can be removed and what can be replaced. This feature, which in normal times is a positive attribute, is likely to wind up constraining capital flows and transactions. This will result in a widening chasm between what is right for the portfolio or individual properties and what is right for investors.

On a related note, CMBS servicers have their hands tied when it comes to defensive moves to retain

tenants or compete in a falling market. In particular, granting forbearance, reducing rental rates, or contracting space for key tenants is problematic at best. At the same time, borrowers seeking to modify mortgages to retain solvency are faced with the challenge that such assets are held in tax exempt trusts. Thus, if discussions are held regarding voluntary loan restructuring prior to delinquency, it could trigger tax consequences. The end result would further thwart such activity and create additional turmoil for the sector, which has already all but collapsed.

To address these issues, the U.S. Department of the Treasury has released new tax rules that make it easier for property owners to restructure CMBS loans. The new guidance rules from the Internal Revenue Service (IRS) make it possible to hold clear discussions regarding interest reductions or increasing loan terms prior to default without triggering tax consequences. The IRS also has increased the permitted modifications to include changes in collateral, guarantees, and credit enhancement, as well as changes to the recourse nature of an obligation.

Private Equity Market

During the summer, the private equity real estate market was uncharacteristically slow, with limited transaction volume. In the face of declining property values and deteriorating income streams, long-term players who were not forced to sell stayed on the sidelines. This situation is likely to hold, although the prospects for additional losses and a prolonged recovery may be enough to trigger owners of weaker properties to start taking action.

Those who do opt to sell will face some sticker shock, as well as pressure for seller financing or structured transactions. While the bottom of the market is not in sight, there are signs that private activity levels will pick up beginning in the fourth quarter. This outlook is based in part on the fact that distressed assets are beginning to show up at an accelerated pace. Indeed, the term *vulture investor* has started to receive some attention, although no one has been able to accurately profile such investors or to determine when they will strike.

Given the lack of access to debt, any increase in private transaction volume will be tempered, with heavy reliance on the willingness of sellers to cut prices to meet the new market standard. Until seller behavior and expectations change to close the bid-ask gap, private institutional buyers will continue to be patient.

At this point in the cycle, the denominator effect will favor real estate with a rising stock market. Declining property values have pushed many institutional investors under the asset allocation floor they had established for real estate. Since the return of such investors is likely to be slow, there are no signs of a white knight that can step in to help jumpstart the market. Cash will be king as sellers try to move product and buyers try to take advantage of the market's collapse.

In the meantime, significant capital is expected to remain on the sidelines as buyers and sellers sort out their positions and determine strike prices. Once that happens, the beginnings of a flood of transactions will occur as the market opens up and confidence rises. That scenario, however, is surrounded by a lot of ambiguity and uncertainty.

Public Equity Market

REITs are posturing to take advantage of the expected turmoil in the commercial market. The REIT industry has raised capital in the face of weakening fundamentals in the underlying real estate market. Indeed, through August, REITs had raised some \$24 billion in new capital, but this is still significantly below the rates earlier in the decade. Indeed, the \$17.5 billion in secondary offerings was the highest rate over that the past ten years, while IPO activity was below longer-term averages.

In this environment, rating agencies are expected to play an important role, focusing attention on liquidity, restricted access to debt, and lower transaction volumes. Going forward, the extent that REITs will be able to step in and take advantage of the surge in distressed asset listings will depend on a number of factors, including the growing pool of capital presumably sitting on the sidelines.

Conclusion

An increasing number of economic signals suggest that the worst of the recession is behind us. Indeed, it appears that an argument could be made that the recession officially ended in August 2009. While the federal government continues to focus additional resources on stimulus programs, a growing number of observers argue they have achieved their goals and should be phased out.

Despite recent improvement in some key indicators, for many who lost jobs, houses, or substantial

portions of net worth, economic activity levels will remain slow. Given the tenuous nature of the recovery, consumers and business confidences are likely to be hopeful but tenuous.

With respect to commercial real estate, values are expected to continue the recent trend in value losses over the next twelve to eighteen months. This trend will be driven by three major forces: the wave of distressed assets that will start flooding the market over the near term; deteriorating market fundamentals as tenants rule the day; and a surge in refinancing activity that will hit the market beginning in 2010. While the federal government may try to help dampen the blow, there is likely to be no safety net to fall back on to bail out the industry.

In this environment, discipline and paying attention to real estate fundamentals will be of paramount importance. In the absence of the ability to capture capital to support the market, the industry is in for some very challenging times. On a positive note, such challenges will create opportunities to build wealth for those with the intestinal fortitude, resources, patience, and vision to make bold, proactive strikes. Unfortunately, that describes a narrow segment of the market.

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