A Return to Fundamentals

by James R. DeLisle, PhD

Commentary

The real estate market in the United States is heading into a critical period in the 2010 fourth quarter. In a number of real estate circles, a renewed sense of optimism has returned to the market, with reports of the easing up of credit and increased transaction activity. However, there are still fundamental risks for the industry.

On the broader economic front, the official end of the recession has helped bolster confidence, leading some to believe that the United States may be moving out of the economic doldrums that have dragged down the real estate market. The global economy also appears to be stabilizing, although few countries are reporting any significant positive growth. Indeed, the recent decision by the Chinese government to increase interest rates raised widespread concerns about the plight of the global economy and led to a wave of sell-offs. This reaction suggests that businesses and investors remain concerned over the potential for a double-dip recession. Thus, decision makers are likely to remain cautious, exposing the economy to downside risk. This general tone will hang over the real estate market, which due to excess capacity will tend to lag the broader economic recovery. That said, there is some positive news on the real estate front, and that has drawn attention from those who have been forced to the sidelines. Whether that positive news will translate to a sustainable recovery over the near term is doubtful, however, suggesting the industry is in for challenging times as it seeks to recapitalize itself and find the bottom of the market.

On a positive note, unlike during the collapse of the early 1990s, the commercial real estate market has not completely shutdown. This is particularly true at the top end of the market, where long-term players have been competing for core assets. While a number of players have seized on these transactions in hopes of a return to normal, the overhang from the withdrawal of easy, cheap credit suggests that the market has a way to go before the backlog of distressed assets is cleared out. In the meantime, transaction activity is likely to be concentrated on a narrow band of assets, with the majority of the commercial market struggling to return to some semblance of normality.

Although it is not clear what the commercial market will look like when it does recover, hopefully it will be more disciplined and more aligned with real estate market fundamentals rather than pure capital market plays. During the current, potentially prolonged, period of adjustment, significant wealth transfer will continue as a result of changes in market values and transfers of ownership. Unfortunately, it will be difficult to determine when that inflection point will be reached. Although the process will be painful, the real estate industry should be on more solid ground, with returns more aligned with spatial fundamentals rather than depending on the vagaries of capital flows.

The Economic Environment

During its September 19, 2010 meeting, the Business Cycle Dating Committee of the National Bureau of Economic Research reported that the recession that began at the end of 2007 ended in June 2009. This belated news was welcomed among those interested in official dates. However, it provided little solace to businesses and consumers that continued to feel the same way as during the depths of the recession. To its credit, the committee did not suggest that the United States had entered a recovery in mid-2009, but merely

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that the trough had been reached and that any future downturn would constitute a new recession.

While the country has avoided a double-dip recession, the growth that has occurred has been tempered, especially compared to other post-recessionary periods. Given the significant infusion of stimulus funding and the concerted effort of the Federal Reserve to hold interest rates low and stabilize the financial industry, the results have been disappointing.

While there are some signs that the economy is stabilizing, the results continue to be rather mixed, resulting in a lot of finger-pointing. This is especially true with the bitter midterm election debates that have called attention to the broader economic environment and the inability to stimulate growth and restore lost jobs. Indeed, many are likely to be nagged by a concern that the progress that has been made may be reversed or muted, forcing policymakers back to the drawing boards. This situation will be exacerbated as a divided Congress digs in and begins posturing for the presidential election year—where the political stakes will be even higher—rather than focusing on the most efficient and effective ways to ensure that the recovery is sustainable and leading to an era of prosperity.

Economic Growth

The U.S. economy has experienced moderate growth in gross domestic product (GDP), benefiting in part from improvement in the financial and credit markets, and the fiscal stimulus provided by the American Recovery and Reinvestment Act of 2009. On the other hand, the cost of the stimulus program combined with the recession created a surge in the federal budget deficit. While the deficit remains a concern over the long term, attention will be focused on the level of growth and whether it is sustainable.

Although GDP growth in late 2009 came in around 5%, the growth rate tapered off in 2010, slipping below the 2% level. This growth rate is likely to continue over the near term. A number of factors have benefited GDP growth, including a modest uptick in consumer spending and inventories along with modest business investment. An increase in export activity also has been moderately positive, although gains were more than offset by a surge in imports. Going forward, the GDP is expected to continue to grow at a modest but positive level. However, the withdrawal of the federal stimulus program and lack of business confidence, especially among smaller businesses, provide some downside risk. Thus, there will continue to be some risk of a double-dip recession, which will act as a governor on the economy.

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One of the lessons of the past several years has been the increasing importance of the global economy and the shifting away from local control over the economic fate of developed countries. The prospect is for a prolonged period of slow growth in many developed countries. Even in a moderate-growth situation, the debt burdens of many countries are projected to increase above annual GDP, with Japan and Greece leading the pack. The actual outcome will depend on the relative growth of GDP as well as interest rates on government debt. For example, the International Monetary Fund (IMF) has forecast that if GDP in the United States grows at a moderate 3% annual rate (which some believe is overly optimistic) government debt will be around 110% of GDP by 2015. If, on the other hand, GDP grows around 1.5%, the debt to GDP ratio would push 125%, creating a cloud that would hang over the economy and put pressure on the dollar.

One key issue raising concern on the global front is the growing conflict over currency policies, including exchange-rate adjustments and current account balances. Some countries are being accused of systematic undervaluation of their currencies, which is putting pressure on other countries that want to remain competitive. Some countries have called for the IMF to intervene and take a stronger stand in pressuring countries to develop more equitable and sustainable currency policies. The recent move by China to raise its interest rates caught many off guard and disrupted global markets as it quickly pushed investors toward safer investments. The far-reaching ripple effects provide a testament to the importance of China to the global economy in general and emerging markets in particular. While the situation is still being played out, it will be closely monitored by developed and emerging markets alike

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that have come to depend on global capital and low interest rates. Indeed, the Group of 20 (G-20) finance ministers and central bank governors will be considering methods to reduce trade imbalances. On the table will be efforts to adopt current account deficit targets and to press China to boost the value of its currency in hopes of finding more sustainable and equitable levels for global balance sheets.

Employment

The labor market has been one of the most closely watched situations by those looking for signs that the United States has entered into a sustainable economic recovery. There has been some progress, with the private sector creating over 860,000 jobs during the first nine months of 2010. Unfortunately, private sector job growth slowed down in the third quarter. Despite some positive indicators that suggest the economy is improving and companies' balance sheets are growing, corporate America has remained reluctant to make a major commitment to new employees. Indeed, rather than making progress in the number of hires, companies have turned to temporary help, which is accounted for over a third of all new jobs.

In terms of job growth, the results have been mixed with education and health services expanding and an increase in travel translating to new jobs in the troubled leisure and hospitality sectors. However, private-sector job growth has been more than offset by the loss of government jobs at the state and local levels as budget crunches have forced another round of belt-tightening. The federal government also contributed to the decline in jobs as the 2010 census program wound down.

In terms of unemployment, the number of unemployed has recently declined although the national averages continue to be stuck at slightly below 10%. There has been some improvement in long-term unemployment, but the percentage of workers joining the recently unemployed ranks has increased as companies have cut back to maintain solvency. Despite the lack of significant new hires, the labor force participation rate has remained relatively stable at around 65%, which is about 2% below the peak reached at the beginning of the decade. Stabilization in the labor force participation rate suggests that workers are anxious to work and willing to take advantage of the job opportunities that come along regardless of whether these are temporary or permanent. At the same time, the number of job separations due to voluntary employee departures has been relatively stable, but significantly below longer-term averages, indicating decreased mobility and options for new employment.

Going forward, the employment situation is likely to remain somewhat tenuous. The recent increase in help-wanted ads suggests that companies will hire over the near term, albeit at rates that are unlikely to make a significant dent in the unemployment rate. In terms of wages, the weak job market will create few opportunities for workers to enjoy significant raises. However, when the economy does improve and jobs begin opening up, many employees are likely to seek new opportunities at higher pay. The employee unrest may lead to greater turnover rates and increased competition, especially for those with the skills needed in fast-growing sectors of the economy. This is particularly true if health care reform provides workers with the ability to seek new employment without having concerns over pre-existing conditions or finding jobs that offer full benefit packages. This trend could also create demand for improved work environments, which could spill over to the commercial real estate market and create opportunities for better product in better locations.

Inflation and Interest Rates

Given the tenuous nature of the economic recovery, the Federal Reserve (the Fed) is expected to continue its aggressive programs to hold down interest rates. There are also some signs that the Fed reinvigorated its asset purchase program to help stimulate growth and increase inflation to more comfortable levels in terms of economic viability. Policy makers are particularly concerned about the lack of employment growth despite the significant monetary and fiscal stimulus programs.

Even with continuation of the low interest rates, the market will be plagued by problems associated with access to credit, especially for smaller businesses. At the same time, consumers and

businesses are expected to be fiscally conservative and reluctant to take on new credit without the prospects for increased earnings. In light of the prospects for modest GDP growth, this situation is unlikely to change over the near term, creating an additional drag on the economy. However increasing corporate profits provide some upside potential once confidence levels increase and companies look for opportunities to grow. Indeed, improved balance sheets having correlated with an increase in investment in equipment and software as companies look at improving productivity as a means of increasing output.

The United States continues to operate in an extremely low inflationary environment. Indeed, attention is focused on the issue of disinflation, which would have significant adverse impacts on the broader economy. The Consumer Price Index (CPI) was just over 1%, on a year-over-year basis through September. A moderate increase in food prices has been offset by softening energy prices, led by the decline in gasoline and natural gas prices. The soft housing market also has helped, although there are signs of modest upward pressure on rental rates as a result in declining ownership. Import prices have also been relatively flat, benefiting in part from the weakness in the global economy. The Producer Price Index (PPI) is expected to experience very modest growth, falling off through much of the year and only eking into positive territory during the past several months.

These patterns are unlikely to change over the near term until business and consumer demand increase. In this environment, the Fed has shifted attention to increasing inflation expectations to avoid the threat of deflation.

Business Indicators

Leading economic indicators have vacillated during 2010, with recent gains recovering some lost ground but still low by historical standards. While disappointing, the level of leading indicators is consistent with a modest recovery and provides some reaffirmation that the recovery will continue.

The majority of business indicators are generally positive and in line with a slow-growth economic recovery. Corporate profits are fairly healthy, with some larger companies taking advantage of low interest rates to refinance existing debt. Conditions in the troubled financial and credit markets have continued to improve throughout the year, although there is some concern over the quality of bank portfolios and foreclosure practices.

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After a healthy start, manufacturing activity has softened over the past several months as businesses respond to the slowing domestic economy and rising concerns over global economic conditions. The need to build up inventories has played out, taking away a temporary source of demand that stimulated growth during the first half of the year. Indeed, inventory-to-sales ratio for wholesale trade are in line with long-term averages and significantly below the peak reached before the recession set in. Capacity utilization is at a relatively low level compared to long-term averages, but still some 6% above the rate a year ago. Thus, businesses are postured to increase output without putting upward pressure on the costs of plant and labor.

Consumer Confidence

Consumer confidence levels have continued to vacillate, remaining mired at the bottom of the trough and far below long-term averages. The recent figures, however, show the very modest uptick. Going forward, consumer confidence levels are expected to continue to languish until the economic recovery takes hold and consumers begin to feel the benefits on the job front as well as in their take-home pay.

Retail Sales

Retail sales have mimicked the choppy pattern of consumer confidence, with periods of gain giving way to periods of decline. Over the past several months, retail sales have improved modestly, although still low by historical standards. The mediocre level of sales gains is even more disappointing when considering the fact that the year-over figures are coming off of weak 2009 levels. However, the fact that sales are above forecasted levels suggests that consumers are not as defensive as they were earlier in the cycle. At the same time, the modest levels of increases suggest that consumers remain conservative and willing to rein in spending until they are more confident in the economic recovery and the impact it will have on their pocketbooks. Going

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forward, retail sales are expected to be somewhat disappointing but in line with the overall economy and consumer confidence levels. This situation is likely to carry through the holiday season, forcing retailers into another round of promotions and discounting to attract consumers.

Housing Market

In the first half of 2010, the first-time homebuyer credit helped attract potential buyers to the market. Unfortunately, evidence suggests that the program was successful in accelerating purchases new homes, but not in creating sufficient momentum to allow the industry to propel forward in a sustainable manner. The same case applies to existing-home sales, which benefited from the incentive program, but declined by more than 25% following its expiration. The lack of construction of new homes has helped reduce the months of inventory levels; however, the dramatic drop in demand has led to the lowest absorption rate since the market collapsed in 2006.

The recent outrage over the mismanagement or corruption in the residential foreclosure market has called attention to the fact that the housing crisis is far from over. It appears that the scandal regarding the rush to foreclose and the failure to obtain clean documents on the downside of the market was as bad as the problems on the underwriting side. The foreclosure crisis cannot have come at a worse time for the fledgling housing market recovery. This situation is likely to get worse as banks begin to remove their moratoria on foreclosures and to clean up the backlog of troubled loans. In this uncertain environment, home builder confidence levels remain low, forcing the industry to remain on the defensive and continue to operate in survival mode. The situation will be exacerbated by the shift in tenure choice as many households question whether they should buy into the homeownership dream.

Real Estate Market

Overview

Over the long term, the commercial real estate market tends to lag the overall economy in recovery. The exception to this pattern is when the federal government has changed tax laws or created other incentives to help stimulate the market in order to jumpstart the overall economy. While significant lobbying is going on in Washington to protect the real estate market, these efforts have been on the defensive as in the case of widespread efforts to forestall changes in carried interest.

At an overall level, the commercial real estate market has begun to show signs that it is bottoming out, although vacancy rates remain relatively high compared to long-term averages. This situation is expected to continue, with the apartment market and the troubled hospitality market providing some signs of improvement and the other property sectors holding their own in terms of fundamentals. Prognosticators anticipate a gradual improvement in real estate fundamentals will begin in mid-2011, assuming the economy stays on track. However the improvement will be guarded due to the overhang of excess capacity and a slow-paced economic recovery.

In this environment, development activity will continue to be on hold, with most developers remaining in a survival mode. Some developers will try to push forward on entitlements and make selective acquisitions in anticipation of the eventual recovery. However, the absence of capital will be a major governor on the industry over the near-to-intermediate term and will help the industry bottom out.

Office Market

Office market fundamentals are beginning to show signs of improvement, with the leasing activity increasing in some markets and vacancy rates stabilizing. New construction remains largely in check. Rental levels have begun to bottom out, but the sector will not recover the erosion in rents until the economic recovery and job growth strengthen.

Although net absorption is relatively flat, a reversal in the decline represents a dramatic improvement from the losses incurred over the prior two years. As might be expected, Class A properties have fared better than Class B and C properties and have experienced a moderate increase in absorption. Sublease activity has also tempered as new tenants

turn attention to dealing with motivated owners in hopes of getting favorable terms that are consistent with market conditions. The decline in job losses has placed something of a floor on additional give-backs, although some tenants have been aggressive in terminating agreements.

In the private market, office returns improved during the second quarter. This improvement was attributed to a modest increase in income returns and slightly positive appreciation. While the positive appreciation was welcomed, the value losses racked up over the past several years remain. For the trailing one-year averages, total returns were down around 2%, which was disappointing but still dramatically above year-earlier figures.

In the public market, office REITs fared much better, with the total return year-to-date of around 14%, which was ahead of the industrial sector but lagging the residential and retail sector.

Office market transaction levels in the 2010 third quarter were up significantly from 2009, but were relatively flat compared to the first two quarters of the year. As with other property types, the market is bifurcated, with top-tier assets trading at record levels in the face of strong investor interest and limited supply. In terms of location, interest has been strongest for CBD assets, creating downward pressure on cap rates at the top end of the market. On the other hand, suburban sales activity has been modest despite cap rates that have been higher than for CBD counterparts.

The pace of office sales is expected to increase in the 2010 fourth quarter as sellers take advantage of the increase in investor interest and present more realistic price expectations. That said, a significant number of distressed assets still hang over the market and are likely to be met with limited enthusiasm among investors until yields increase to compensate for the added risk they entail.

Retail Market

The retail market has been under some pressure as consumers continue to rein in their purchases. Vacancy rates have continued to increase modestly although store closings have slowed down. However, due to excess capacity, some additional erosion in rental rates is likely, with the exception of well-located projects that benefit from strong demographics and consumer demand.

Despite operating in a defensive mode in general, a number of retailers have planned new store openings to position themselves for the anticipated economic recovery in 2011. The bulk of these store openings involve discount and off-price retailers, although some mid-priced retailers are expected to get on board to respond to shifts in demand. Larger retailers are also experimenting with new store formats. This activity includes some of the big-box retailers that are experimenting with smaller stores, such as fresh food formats, as well as those seeking to move into urban locations in response to infill development. While such experimentation is likely to continue, retailers are expected to retain their focus on unit profitability and pull back if the new concepts do not gain traction.

Private retail investment performance, as reflected in the NCREIF Property Index, improved in both the 2010 second and third quarters. Although total retail returns remain marginally negative, they were competitive with the apartment sector and ahead of the hotel industrial and office sectors.

On the public front, retail REITs had the second-strongest performers and year-to-date figures through the end of September, with total returns above par at 21%. Regional mall performance was slightly stronger than smaller shopping centers, despite concern over the format. In much-welcomed news, General Growth Properties announced in October that it would be emerging from bankruptcy by mid-November; this should help bolster regional mall performance in terms of stock prices. Investors will likely continue to focus on consumer confidence and consumer spending, however, and this may place a damper on the sector over the near term.

In terms of transaction levels, retail property sales increased significantly in the third quarter compared to the prior year and double the level in the first half of 2010. The sales figures were amplified by Simon Property Group's acquisition of Prime Outlets after a period of prolonged negotiations. As with other property types, the market remains bifurcated, with cap rates declining for high-quality, grocery-anchored centers. The volume of distressed retail assets appears to have peaked, but the industry has made little progress on cleaning out the queue. In anticipation of improved interest in retail acquisitions, the volume of properties for sale has increased and bid-ask spreads have begun to come back in line

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for closed transactions. However, the flight to quality is likely to put additional downward pressure on values until the retail market fundamentals begin to improve.

Industrial/Warehouse Market

The industrial market has begun to exhibit some positive signs, with vacancy rates reversing from their upward trend. One major factor behind this recovery is the almost complete shutdown of new product, which has led to moderate but positive absorption rates. The limited construction that has occurred has been concentrated in the build-to-suit sector, with speculative construction all but absent from the scene. The slowdown in manufacturing has created a temporary damper on demand, but it is anticipated that the sector will continue its moderate recovery as the economy begins to pick up in import and export volume.

As with other property types, industrial returns in the private sector have trended upward. Income returns on industrial properties in the NCREIF Index led other property types and are more in line with long-term averages. Interestingly, the situation is quite different on the public side of the market, with industrial returns on the negative side of the equation—the only property type experiencing such a plight.

The industrial property market has enjoyed a consistent upward trend in transaction volume over the past two years. This increase has been bolstered by sales of larger portfolios in the 2010 third quarter. Compared to last year, industrial sales have increased around 60% in terms of value, driven by a surge in REIT acquisitions. On a per-square-foot basis, prices have trended upward. Cap rates have trended slightly upward for warehouse properties, while smaller flex properties have declined moderately, as a result of stronger performance and investor interest for properties with tenants in growth sectors of the economy.

Apartment Market

Among the major property types, the apartment sector has received the most significant attention in terms of potential for a near-term recovery. This recovery can be attributed to a number of factors, including recognition of the renewed interest in renting versus owning. The apartment market should experience additional upside potential since the single-family market is likely to remain in the doldrums for some time. The upside trend is expected to accelerate when the economy begins to pick up, and employees move to take advantage of new job opportunities. This will create more opportunities for the apartment sector, especially in markets that will benefit from strong net migration. At the same time, limited construction activity should help firm up vacancy rates and take pressure off of landlords to offer concessions. The strongest performers are higher Class A properties, as renters exhibit a flight to quality. This trend should lead to improved bottom-line performance and increases in values of well-located assets.

Apartment market transaction activity continues to trend upward over the past year. This situation is likely to carry into 2011, as investor demand grows and sellers become more realistic with pricing expectations. Through the 2010 third quarter, apartment transaction volume was double that of 2009, in part due to an increase in transaction values as larger projects traded on the open market. Transaction value volume was also bolstered by a moderate decline in cap rates as sellers attempted to clean out the queue. Due to strengthening conditions at the top end of the market, however, cap rates have begun to decline, with mid- to high-rise properties pushing 5% as investors scrambled for core assets.

Real Estate and Capital Markets

Capital Market Overview

The capital markets are showing renewed interest in real estate activity, although that attention is focused on the top end of the market. This situation is likely to continue with the pressure on placing capital ultimately forcing investors to move down the food chain from the narrow, fully priced top end of the market.

As investors are forced to sift and winnow among the many distressed and opportunistic properties on the market, it will be difficult to determine the proper acquisition prices. At the same time, investors will have to figure out how to reposition assets and

create value through the application of fundamental real estate skills rather than capital market acumen and financial engineering. Investors will also have to pay more attention to the risk side of the equation to ensure they are getting properly compensated. Since risks will vary by property type and subtype, as well as by location and product positioning, valuations will take on greater importance than in the past when commoditized pricing dominated the market.

Equity Investment

Over the past several years, significant volume of equity capital has been raised to take advantage of opportunities in the market. While transaction activity has increased during 2010, the bulk of capital remains on the sidelines, as investors wait for better opportunities on the core-plus side of the market.

Among investors who have been active, the pack has been led by institutional investors and private equity or opportunity funds. Many of these players have already come to terms with the fact that real estate is inherently an income vehicle rather than a growth vehicle and have adopted a long-term hold strategy with lower return and lower risk tolerances. REITs have also been active and account for some of the larger portfolio level acquisitions.

One major challenge faced by some of the newer opportunity funds is recognition that it will be difficult to hit the 20% hurdle rate that opportunistic investors have come to expect from commercial real estate. While some argue that investors will have to be content with lower earnings, concern over the risk side of the equation makes that argument somewhat tenuous. Investment managers who will be held to the higher expected returns will be forced to be patient and wait for banks' special servicers and underwater owners to discount their distressed assets en mass rather than having them trickle out as in the recent past.

With the clock running on time-weighted hurdle rates necessary to trigger incentive compensation plans, managers will be pressured to move down the food chain, taking on projects with inherent risk that will have to be ameliorated to balance the risk return side of the equation. No doubt some will be forced to roll the dice and hope that the broader economic recovery will provide some insulation from additional downside risk. While this may be true on a project-by-project basis, the rules of engagement have changed from the past when commoditization created a rising tide that carried all properties regardless of the quality of underlying market fundamentals. This will lead to greater price differentiation and discrimination among buyers, which may be subverted by the pressure to do deals.

Over the past several years, sovereign wealth funds (SWFs) have played an increasingly important role in global capital flows. While still pumping significant capital into offshore investments, activity declined to around $20 billion for the first half of 2010 compared to almost $60 million in the second half of 2009. This decline in investment activity attests to rising concern over the fragile global recovery and possibility of a global double-dip recession. Capital flows will continue to be tenuous until the global economic situation stabilizes for some key countries. At this point, it is not clear which countries are postured for such growth, and what would drive their economic revival sufficiently to create a positive halo for the rest of the world's economies.

The contraction in capital flows is likely to spill over to the real estate market, which has captured a significant proportion of SWF investments and has been seen as a potential source of recapitalization of the troubled real estate market. At the same time, global real estate capital flows into the United States, at an overall level, are expected to increase dramatically, with estimates of around $100 million. This would account for about one-third of total global real estate investment activity flowing into the country. While investment activity is expected to continue to grow, investors will be more guarded and will focus on market fundamentals rather than capital or currency plays.

Mortgage Market

The commercial mortgage market has begun to show some signs of life, although that activity has been concentrated at the top end of the market in terms of high-quality product and strong borrower balance sheets. For the market as a whole, access to capital remains problematic especially for borrowers holding distressed assets where undercapitalized players tried using leverage to take advantage of favorable pricing.

This commercial market situation is likely to continue as lenders focus on the quality of their loan portfolios by being selective in offering new loans and restructuring existing loans. Despite the modest increase in loan activity, their willingness to look at

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new opportunities is expected to remain conservative in terms of underwriting standards. Borrowers will be forced to accept lower-than-desired loan-to-value ratios. Many borrowers will also have to deal with recourse loan requirements, as lenders respond to the risks they introduce to their portfolios in the absence of a viable securitized market.

On a somewhat positive note, the growth in delinquency rates on commercial mortgage-backed securities (CMBS) slowed toward the end of the 2010 third quarter, marking the slowest increase in two years. While this was welcomed news, there are few signs that the delinquency rates will improve until the economy gains momentum and real estate markets begin to tighten up. The modest improvement in distressed loan holdings can be partly attributed to an increase in workouts and/or dispositions of troubled loans. The pace of solutions for troubled loans has begun to offset the growth in new delinquent loans.

In terms of property types, the greatest increases in delinquency rates were in the hotel category. Industrial and office rates increased, although they still remain at the lowest level among the major property types, with retail at a slightly higher rate. On the other hand delinquency rates on apartment properties actually declined, although they still remain at an uncomfortable level in the low-double digits. These patterns are consistent with trends in underlying property-type market fundamentals, offering further evidence that the spatial and capital markets are beginning to converge.

Conclusion

Over the next several years, the commercial real estate market will struggle for new sources of debt capital to replace the largely dormant CMBS industry. With record levels of refinancing activity on the horizon, the industry faces major challenges in terms of recapitalization. At some point, someone is going to have to take the hit for the underwater properties and recognize that an extend and pretend approach merely prolongs the agony.

Thus, the commercial real estate market is at something of a crossroads. While it appears that market fundamentals have bottomed out, the overall outlook suggests the industry faces a rocky road with a number of obstacles that must be overcome before there can be a return to normal times. During this process the definition of normal times will come into question. Those waiting for the market to return to the heyday period experienced over the past decade will be disappointed. While healthy in the long-run, the adjustment period will be painful and fraught with peril, especially for those who fail to refocus attention on the underlying fundamentals of supply and demand, and approach real estate as a resource that must be managed in a proactive manner rather than a financial asset that can be merely bought and sold on the open market.

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