White Paper No. 47

The Real State of Real Estate

Greycourt

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When asked during World War II whether he believed the end was near, Winston Churchill said that "now is not the end. It is not even the beginning of the end. But it is perhaps, the end of the beginning." This could sum up our thoughts on the real estate market. Major issues continue to burden the real estate market while certain pockets of opportunity are beginning to present themselves. The housing market is still a mess but it is starting to look "less bad." Commercial real estate is facing a massive tidal wave of compulsory refinancing at a time when little exists, yet there is some optimism that a form of the securitization market will eventually return. TARP, TALF, PPIP and other strangely acronymed government programs are just now going into effect – how they will affect the real estate market is unclear but there will no doubt be a significant short-term effect on the economy, and that may help stem the current slide in real estate fundamentals. Make no mistake, we are not at the bottom. But we may be approaching the end of the top.

Residential housing remains over-supplied. Recent up-ticks in home sales reflect a slight relief in pent up demand as well as bottom-fishing from vulture investors, *not* a return to normalcy. Some markets (notably Arizona and Nevada) are in the worst shape because of lower barriers to entry that existed during the housing boom. Other markets with over-supply (California and Florida) are also in for difficult times but we believe their recovery will be relatively quicker, due to continuingly higher entry barriers and more natural demand for those markets. As an example, Florida still counts nearly 1,000 new residents per day on average, many of them younger than 100 years old.

> *Housing prices will likely continue to fall albeit at a slower pace. Depending on the particular market, housing supply will continue to outstrip normal demand for at least 12-36 months. Significant government intervention in the residential mortgage market will have a positive effect, but a return to normal supply and demand will require improving fundamentals (job growth in particular).*

Commercial real estate lending markets are largely frozen. Leverage is a critical component of the real estate market, as most real estate maintains significant debt against the asset. Because the CMBS market has shut down, any new debt being issued will need to be "on balance sheet" meaning whatever institution originates the loan will likely need to keep the loan on their books, and that's not happening, as banks (and other lenders) are not extending credit.

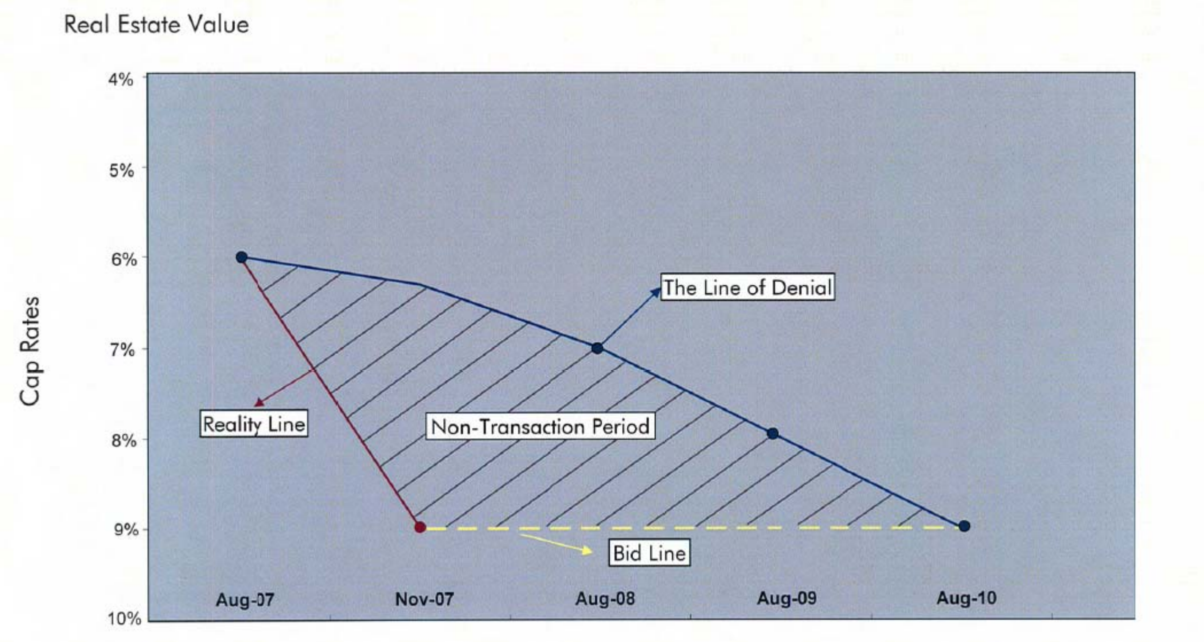
We believe commercial real estate lending will return and the CMBS market will recover, albeit in a different form and with more regulatory and underwriting constraints attached. We are already starting to see some clearing of the existing CMBS stock in the marketplace, although new CMBS issuance of any significance is probably 12-18 months away, and that issuance will likely be restricted to assets with very high intrinsic equity value and very strong sponsors.

Real estate fundamentals are deteriorating. Up until now, much of the pain experienced in the real estate market has been financially driven – loan maturities not extending or borrowers under pressure due to reduced asset values in other areas of their portfolios. Fundamentals up to this point have been fairly stable – rent prices and vacancies in particular. We are, however, starting to see the effects of the overall economy on real estate – tenants are beginning to default, vacancies are rising, and pricing of new rental stock is coming in significantly lower than existing rents.

Due to the lag effect described above, real estate will likely continue to suffer even as the overall economy recovers. Fortunately, we generally do not have the over-supply problem reminiscent of the last downturn (1989-1992), but that will largely be offset by the economy being worse than before. Ongoing job losses will eventually taper off but it is unclear when job growth returns, which will be a key driver of improving real estate fundamentals. We expect fundamentals to remain weak for an extended period of time, likely beyond the eventual recovery of the overall economy.

The Line of Denial

Ethan Penner at CB Richard Ellis beautifully demonstrated (see the chart, below) what many of us have been thinking – namely that real estate prices as defined by *sellers* do not reflect the true value of real estate assets as defined by…um, reality. The question is when do the lines intersect; that is to say when does perception become reality and seller expectations are in line with what buyers are willing to pay. It's a crucial point in time because that is when we will start to see transaction activity occur, which will free up the logjam of transactions, which will start to put a true value on real estate for the marketplace to evaluate, which will facilitate more transactions, and so on, until we return to a normalized level of activity (thereby reaching the proverbial "bottom" of the market).



Source: Ethan Penner, CB Richard Ellis.

Each line has its own driver – the **Line of Reality** is driven by the number of available buyers in the market, which we believe will remain steady (i.e., low) for the foreseeable future. Capital availability for buyers isn't an issue; it is simply that valuations are still too high, given today's market conditions.

The main driver for the **Line of Denial** is simply the clock – we are getting closer and closer to the point at which the debt placed on many assets will come due, and that will force sellers to refinance (highly unlikely in many cases, at least at the same leverage levels and pricing as before) or sell assets into the market. Either way, prices will drop, and buyers and sellers will finally begin to meet. The timing of this meeting is up to debate but the general consensus we are hearing is 12 – 18 months from now.

Real Estate Today

With respect to real estate, our view is pretty straightforward: we're in the midst of a cycle. Granted, it's a bad one, but it *is* a cycle. Globally we have apparently stepped away from the abyss; it does not appear that our worldwide financial system is in imminent danger of collapsing, and the real estate market, which relies heavily on that system, can breathe a short sigh of relief. We fully expect the real estate market to recover eventually, but recovery depends on the following:

- **Private markets need to correct.** Lenders must begin clearing their books, taking necessary action to clean up their balance sheets and force owners who are over-leveraged to sell assets.

- **Debt must be available.** Significant amounts of equity on the sidelines sitting in private funds will not be enough – the real estate industry relies on debt to operate, and we must figure out a way to return to the original concept and intent of the mortgage-backed security.

- **Confidence must return to the securities markets.** The government must inject itself into the securities markets to provide investor confidence that the securities markets will function normally. REITs are a proxy for the overall industry; once investors return to the public markets, the private market will begin to function again.

- **The economy needs to improve.** Even with a functioning debt market, an accurate accounting of assets, and a high degree of confidence in the markets, the industry will still suffer until the overall economy improves. Real estate is a direct gauge of the real economy – jobs, inflation, commodity prices, etc. – and as such it will not improve until the fundamentals of the economy begin to recover.

The current environment is creating opportunities as seller distress is growing. We are beginning to see instances of good assets with generally solid fundamentals beginning to trade at highly depressed prices, as owners find themselves in distress, either due to leverage or other investments under stress (or both). However, as with all market dislocations, investors will need to be especially prudent in analyzing opportunities and understanding what distress really means.

Beware of Distressed Funds. Even in this environment, a significant amount of capital is sitting on the sidelines waiting to come into the market, and a number of managers are raising "distressed" funds – funds that will focus their investments on taking advantage of the distressed opportunities that we noted above. The problem is that investing in distressed assets requires particular experience that many managers do not have, namely:

  - Lender work-outs: renegotiating loan terms

  - Tenant negotiations

  - Experience working with municipalities in restructuring assets (particularly development or in-process construction)

  - Handling employee issues during a challenging period of ownership

When looking at fund managers who are proposing a distress product, it's critical to understand their experience in these areas. A good test is how much investing they've done over the last few years; managers who truly focus on distressed investments will have had very few transactions during the recent boom.

Suggested Strategies

Overall, sound strategies in real estate are not unlike sound strategies in other asset classes: take a long-term view, focusing on meeting target allocation ranges, but stay alert for short-term opportunities and risks that are present in the market. This market will provide ample opportunity to realize above-average returns for investors who are patient, careful, diligent and a little skeptical.

- **Maintain allocations to real estate.** As mentioned above, real estate is a core component of a diversified portfolio; it should be part of the asset allocation exercise and therefore, to the extent the allocation provides for it, investing in real estate should be consistent throughout the portfolio's timeline.

- **Focus on credit opportunities verses traditional equity investments.** The dislocation in the real estate market is being driven by a number of factors, specifically the lack of debt financing due to the usual sources of liquidity having evaporated. This has created an opportunity to acquire existing debt instruments at substantial discounts to par value, so much so that the ultimate return on investment will likely exceed that which would otherwise be provided through an equity investment (which has higher risk as it is unsecured and lower in the capital structure). Investors need to be careful here – there is a lot of debt being traded which isn't worth even the pennies on the dollar at which it is being priced. On the other hand, a lot of high-quality investments have been tainted with the same brush; identifying managers who are experienced and successful in finding those opportunities will yield strong results.

- **Focus on core markets.** During the "boom" cycle, investors began to branch out from the traditional, core markets and into secondary environments in an attempt to provide a higher rate of return. This is true both in terms of product (i.e. moving up the risk curve into development) and geography (i.e. moving out of Paris and Munich and into central and eastern Europe). In today's market, we believe it is important to return to product and geographies that are more traditional and proven – they will weather the storm better as their fundamentals are stronger and less reliant upon growth.

- **Focus on product types with defensive characteristics.** Real estate's ability to recover is highly dependent upon the overall economy, the outlook of which is gloomy at best (and severely depressing at worst). Given an unknown but likely bleak economic outlook (at least in the near term), emphasis should be on investing in sectors and property types that are defensive in nature: multi-family properties in particular but also some core industrial and office investments (also called "need-based" real estate). We also like niche strategies that tend to be less correlated to the general market – self storage and medical office as an example (also known as "need-based" real estate). Retail and hospitality are highly sensitive to the economy, almost in real time, as property values depend on consumer spending, which is expected to be lower than normal for the foreseeable future. Residential housing will begin to look attractive from a relative value standpoint (prices being down 50% or more from their peak in certain markets), but activity will still be limited as buyers face an uncertain economy (job losses) and challenges to accessing mortgages (frozen credit markets). Also, there remains a massive amount of housing stock held by banks that has not been released into the market – that will take time to work through as well. We have steered clear of what has become a popular investing strategy for fund managers – buying residential properties en masse from financial institutions or distressed owners. We just don't see a profitable exit strategy.

- **Look for opportunities in the secondary markets.** Secondary investments are investments in funds already existing and, in many cases, already invested in their underlying assets. Secondary opportunities arise when an existing investor in a fund is seeking to exit the investment prior to the fund's natural termination. Reasons can vary but in many cases such investors are looking for liquidity due to issues related to the rest of their portfolio (outside of this investment). In some cases, these investments can be lucrative to new investors as existing investors may be willing to take a substantial discount to the value of their holding just to get out of the investment (and out of any future commitments). Secondary investments are proliferating in today's market as investors who are overweight in illiquid assets are trying to generate liquidity any way they can. The key to evaluating secondary investments is determining whether or not the *investor* or the *investment* is distressed. Secondary investment opportunities that are occurring as the result of distressed *investors* should be considered as they provide a unique opportunity to acquire known assets at a discount.

Real estate as a tradable commodity has existed for centuries but has only recently become an accepted asset class in traditional investment portfolios. Understanding the reasons behind real estate investing and the investment options available, and knowing what to look for, will help investors make the right decisions from which they will profit over time.

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