

CONTRADICTION IN TERMS

FUNDAMENTALS AREN'T EXPECTED TO IMPROVE,
BUT ANALYSTS REMAIN POSITIVE ON REITS

BY ALLEN KENNEY

WITH THE GLOBAL ECONOMY still emerging slowly from a severe recession, analysts are predicting that the commercial real estate market's major fundamental measures, such as rents and vacancies, should continue to weaken in 2010. Yet, in the next breath, many are speculating that REIT stocks should continue to show growth this year. It's like a rain storm when the sun is still shining.

Ironically, the struggles of 2010 actually should catalyze the gains, according to Jonathan Litt, managing principal of Land & Buildings Investment Management.

"Real estate fundamentals will likely bottom in 2010, which should drive stock prices up as public companies best positioned to benefit from a recovery begin to forecast net operating income growth in 2011 and beyond," he says.

One concern is that coming out of the bottom of 2009, REITs and the market may get ahead of themselves in terms of valuations, according to Gil Menna, partner at Goodwin Procter and co-chair of its Real Estate, REITs and Real Estate Capital Markets Group. "If the market does indeed stabilize and doesn't get too far ahead in

terms of valuations, then that will be good for maintaining this recovery," Menna says.

Scott Robinson, a professor at New York University who serves as co-director of the school's Schack Institute of Real Estate REIT Center, notes that most forecasts put U.S. REIT total returns for 2010 in the range of 5 percent to 10 percent. However, that doesn't mean some companies won't have opportunities to produce outsized returns.

"I would expect that those managers with greater investment flexibility and superior property knowledge could significantly outperform the FTSE NAREIT U.S. Real Estate Index in 2010. Managers with relative value, long/short strategies and the capability to invest up and down the capital stack will be better equipped to navigate a year of shaky economic and commercial real estate recovery," he says.

With most worries about the immediate dangers of the latest downturn behind the industry, commercial real estate investors are now trying to decipher how the market has changed.

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2009 Rewind

After bottoming out in early March 2009, domestic REIT stocks took off in the final nine months of the year. The FTSE NAREIT All REIT Total Return Index finished the year up 27.45 percent. REITs also prospered on a global scale, as the FTSE EPRA/NAREIT Global Real Estate Index, buoyed by strong gains across all regions, amassed a total return in excess of 40 percent.

The run-up in REIT valuations largely relates back to the wave of efforts to recapitalize companies' balance sheets worldwide in 2009, according to Kenneth Rosen, chairman of Rosen Real Estate Securities. In the U.S. alone, REITs raised about \$35 billion in fresh capital through public equity and debt offerings.

"The stock prices moved dramatically in 2009 because of all the liquidity we had in the marketplace," Rosen maintains.

While REIT stocks were gaining, however, other measures of market health were deteriorating. Vacancy rates among all sectors began to tick upward, while net operating income and rents started to fall.

By November 2009, the Moody's/REAL Commercial Property Price Index (CPPI), which measures the change in transaction prices on repeat sales of commercial real estate assets at different points in time, had dropped in excess of 40 percent from the market peak in late 2007. The CPPI's 1 percent increase in November 2009 marked its first positive gains since September 2008.

Fundamentally Speaking About 2010

From a fundamentals standpoint, observers' opinions about the near-term outlook for fundamentals all seem to fall somewhere on the pessimistic side.

The rating agencies provided glum assessments in early 2010 of the immediate outlook for commercial real estate. Moody's Investors Service reported that it expects "commercial real estate prices to decline further in the months ahead."

Likewise, Standard & Poor's said in a February report that problems stemming from commercial mortgages could still lead to heavy losses going forward, as delinquencies increase and prices decline.

"As vacancies drop quickly in 2011 and 2012, rents and operating incomes will rebound. But, 2010 will be tough sledding for all the major food groups in commercial real estate," says Hans Nordby, global strategist with Property and Portfolio Research (PPR), a CoStar company.

Nordby notes that, with the usual lag between the commercial real estate market and the overall economy, the picture should continue to darken. "This lag works against commercial real estate during economic recoveries, as the broader economy can be growing at a good clip before office buildings see increased occupancies, retail shop space leases up and warehouse tenants get brave and take down additional space," he says.



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For example, PPR projects that office vacancy rates will climb from the "dreadful" level of 20.2 percent at the end of 2009 to a "truly awful" 21.2 percent by year's end, according to Nordby. Likewise, Nordby says to expect negative growth in net operating income for apartment companies, which won't begin to see occupancy rates increase until the overall economy starts to create new jobs.

Rents and occupancies could begin to turn around in the second half of 2010, even if net operating income remains depressed, according to Litt. That positive trend should continue into next year eventually driving NOI gains, he says.

Robinson also foresees the possibility of a similar rebound in fundamentals in the last six months of 2010, so long as the broader economic picture continues to improve.

"If we indeed see a solid U.S. economic recovery, I suspect commercial real estate fundamentals have bottomed out and may actually show signs of improvement in the second half of 2010. However, if the economic recovery stalls, then property fundamentals will also drift along their current condition," Robinson says. "It would take an additional economic retraction for fundamentals to worsen from current levels."

Ron Sturzenegger, managing director and global head of real estate, gaming and lodging with Bank of America Merrill Lynch, says it is important to remember real estate lives in the overall economy so any recovery in real estate is dictated by economic recovery, most importantly job creation and job growth.

"Real estate is a lagging indicator of the overall economy by six to 12 months," Sturzenegger says. "So once job growth begins and the economy starts to improve, you won't see it show up in real estate fundamentals until up to a year later."

But savvy investors are closely monitoring economic indicators and putting their money into real estate sectors they expect to be on the leading-edge of that recovery timeline. Marty Cicco, managing partner of MJC Associates, says he expects to see that take place in particular in the multifamily and hotel sectors.



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Unforeseen Consequences of Federal Action

There's also the matter of the federal government's suite of public policy initiatives. Monetary policy and the government's financial stabilization efforts, such as the Public-Private Investment Partnership (PPIP) and Term Asset-Backed Securities Loan Facility (TALF), if continued, could impact commercial real estate's overall performance in unanticipated ways in 2010.

The Treasury Department, working in conjunction with the Federal Reserve and Federal Deposit Insurance Corporation, introduced the PPIP program in March 2009. In general, the program sought to stimulate the availability of credit and promote price discovery in frozen markets by helping financial institutions address so called "legacy assets"—loans already held on banks' books and securities backed by portfolios of loans that already exist.

The TALF program, which was instituted in November 2008, allows the Federal Reserve Bank of New York to make loans secured by asset-backed securities rated AAA. Under the program, CMBS qualified as eligible collateral for five-year loans financed by government funding.

Additionally, the Fed has cut interest rates to rock-bottom levels.

Opinions about the impact of these efforts seem to be mixed.

"Anything targeted specifically to commercial real estate really didn't make much of a difference," Rosen says.

Nordby offers a different take: "I would argue that efforts behind TALF, despite putting out a relatively small amount of government funds, have acted to jump start commercial real estate lending. The TALF program inspired investors to look hard at opportunities the government was offering for strong returns, but, just as importantly, it lent a stamp of approval to the assets being packaged. This brought capital into the space and pushed down spreads for other securitized deals."

Menna adds that even though the securitized debt market has shown signs of life, federal support is still needed to build and maintain a healthy, functioning CMBS market long term.

Despite the divergence in views on the realized effects of the government programs, observers do appear united in a somewhat anxious opinion about their impact farther down the road.

"I believe these broad and creative programs did serve their primary purpose, but I have been concerned about the unintended consequences since early 2009," Robinson notes. "The liquidity was necessary to shore up investor confidence in the broader financial system, but that liquidity is very difficult to reverse and could lay the groundwork for inflation and other asset bubbles."

Robinson also points out that the government's intervention



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in the financial markets may have skewed the general sentiment within the real estate investment community.

“The unprecedented amount of government support during a time when investors had no appetite for risk has resulted in an increasing dependence on this support,” he says. “This support has been partially responsible for the lack of commercial real estate property trades—distressed or otherwise—which are necessary for price discovery and an ultimate recovery. There does appear to be an increasing amount of appetite for risk by real estate investors, but it remains tepid and could easily be derailed by a hiccup in the economic or fundamental recovery.”

Litt notes that the mood in Washington remains key to REITs sustaining their growth. “If the mood in Washington is one that is no longer supportive of continued stimulus policies, I think that’s a very big risk.”

Yet, according to Rosen, the government may need to tap the brakes on some of the policies credited with fueling the economic expansion. Notably, the Fed could be forced to raise interest rates before the end of 2010, he says.

Pricing and Expanding the REIT Space

“REITs may have rallied too much in 2009,” Rosen says. “I think we have prices ahead of earnings and fundamentals in both the

real estate market and public equity markets as a whole.”

Robinson contends that because REIT securities are “priced to perfection” by the markets, the possibility of another correction in pricing isn’t out of the question.

“Investors have bid these assets to levels that anticipate both a recovery in cash flow and significant decrease in systemic risk; risk premiums have decreased dramatically. I would not say that a bubble has formed, but current pricing leaves little room for performance missteps or a lackluster recovery,” Robinson says.

However, overall, Robinson says there are exciting prospects for expansion in the REIT securities market in 2010.

“This expansion will come from a likely wave of IPOs from large property owners looking to clean up their balance sheets and expand their access to liquidity; significant private-to-public acquisitions; and to a lesser extent, blind-pool IPOs,” he says. “This expansion will give investors more selection, create future public-to-public investment possibilities, and increase the overall transparency of the commercial real estate industry. The expansion in the REIT space could ultimately lead to a recovery in investor appetite for other CRE securities such as CMBS, though that will be later in the recovery cycle.” ♦

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