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# THE LINNEMAN LETTER

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This an excerpt from the Fall 2010 issue of *The Linneman Letter*.

## Real Estate Capital Markets Are Alive, If Not Quite Well

To date, there have been about \$240 billion of distressed commercial real estate loans, of which \$40 billion has been fully resolved. Another \$40 billion has been restructured via some version of blend-and-extend, \$30 billion has been classified as Real Estate Owned (REO) by banks, and another \$140 billion is performing but troubled.

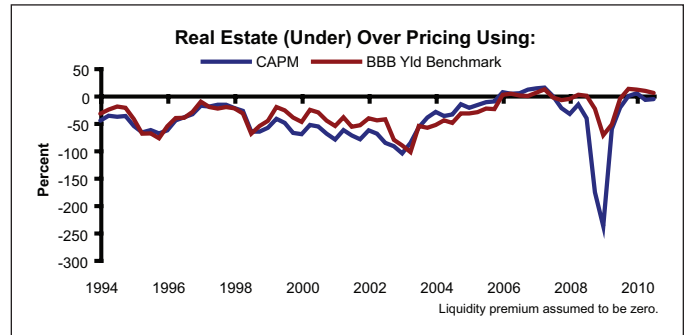


figure 2

### Sales Transaction Activity

	YTD Thru July 2009			YTD Thru July 2010		
	Total Volume (\$ billions)	Avg Price/SF or Unit	Average Cap Rate	Total Volume (\$ billions)	Avg Price/SF or Unit	Average Cap Rate
Office	\$7.8	\$197	7.9%	\$15.9	\$179	8.3%
Industrial	\$4.6	\$67	8.4%	\$6.3	\$61	8.4%
Multifamily	\$6.9	\$85,362	6.9%	\$11.8	\$104,381	6.9%
Retail	\$4.8	\$151	7.5%	\$7.1	\$142	8.1%
Hotel	\$1.6	\$103,149	9.9%	\$3.6	\$119,394	6.9%

Source: Real Capital Analytics, Linneman Associates

figure 1

According to Real Capital Analytics, year-to-date sales activity through July 2010 increased for all major commercial sectors (office, industrial, multifamily, retail, and hotel), compared to the same period in 2009, with the office and hotel sectors more than doubling. However, average unit prices dropped for the office, industrial, and retail sectors over the same comparative periods. Office and retail cap rates increased by 40 and 60 bps, respec-

tively, while industrial (8.4%) and multifamily (6.9%) cap rates were both flat year-over-year. Unit pricing for the multifamily and hotel sectors increased significantly.

Since peaking in the fourth quarter of 2009, total REIT implied cap rates have fallen by approximately 260 bps, from 9.2% to 6.6%, representing an FFO multiple increase from 10.9x to 15.2x through mid-September 2010. Our analysis suggests that as of September 2010,

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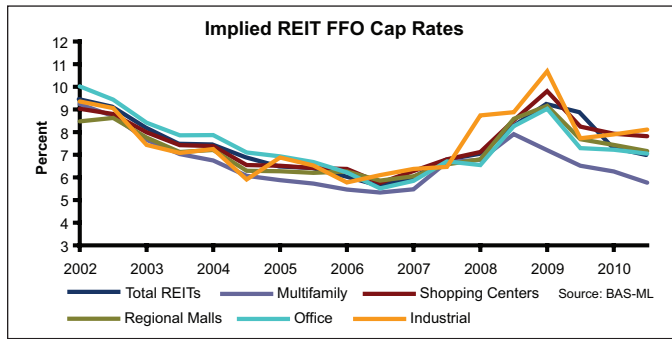


figure 3

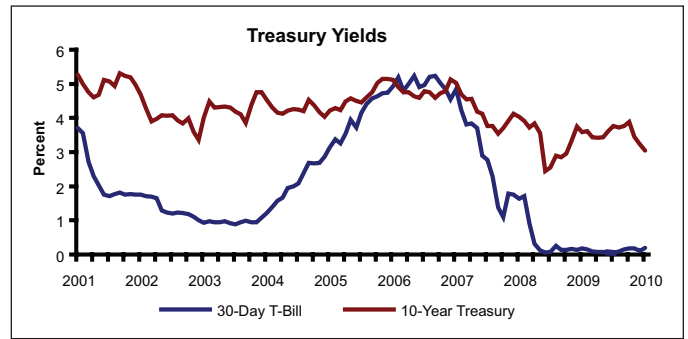


figure 5

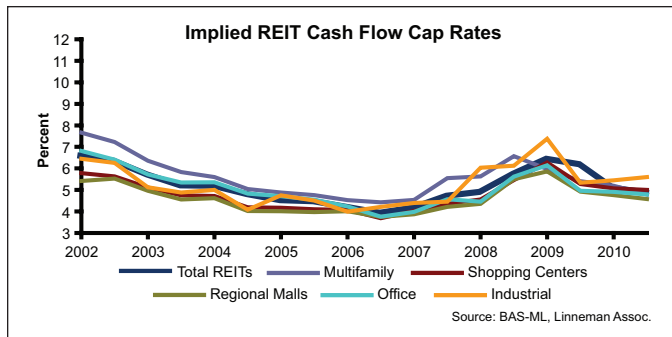


figure 4

2.5% for the past two months, what if the bond market is right?" The bond market is saying that it believes the U.S. can sustain huge federal budget deficits and substantial liquidity injections from the Fed without any inflation for the next decade. Were this to occur, à la Japan, we would be shocked. There is nothing that bond traders know that you do not know. As a long-term commercial real estate investor, you must make your own determination of expected inflation over this time horizon, and cannot "outsource" this task to the bond market.

REITs are approximately 6.4% under-valued relative to BBB bonds, and 4.8% over-valued based on the Capital Asset Pricing Model.

Today's real estate prices for cash-flowing properties reflect the assumption of a strong recovery, but one that will require 3-4 years to replace the 8.4 million jobs lost during the recession. If you believe that significantly fewer jobs are going to be created during this time, you will be outbid. On the other hand, if you believe (as we do) that job formation over the next three years will be in excess of this rate, this is a good time to buy.

Real estate exists solely for the purpose of servicing the economy, so one of the reasons real estate has done really badly in the last two years is that the U.S. lost 8.4 million jobs. The challenge for real estate investing today is establishing a view on the U.S. economic recovery, because if we add lots of jobs, real estate will do very well. But if the U.S. economy loses another 8 million jobs over the next two years, real estate will be killed no matter how well it is managed. Year-to-date through August, the U.S. economy has added 723,000 jobs. If the economy keeps up this pace, we are going to see real estate get a lot healthier over the next three years.

The critical question facing real estate investors today is, "With 10-year Treasury rates hovering around

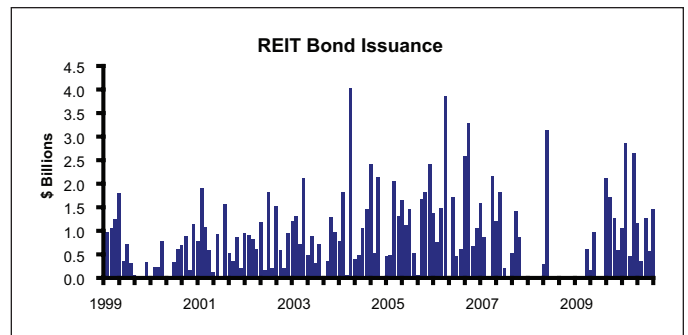


figure 6

If the bond market is right, and inflation is a mere 0.5% annually over the next decade, it will have dramatic implications for commercial real estate pricing. First, real estate borrowing costs will fall dramatically. If 2.5% is the base interest rate, then yields on commercial real estate debt will fall accordingly. But if 10-year Treasury yields remain at 2.5%, borrowing rates for commercial real estate will fall to 3.5-4.25% for 60-70% LTVs on cash-flowing assets. Over the next three years, such low rates will allow much of the maturing debt on cash flowing properties to be refinanced much more easily than anticipated. Higher than expected inflation will be reflected in future real estate cash flows, while the coupon on a government bond remains unchanged. Lower cap

rates, combined with lower borrowing costs, mean that most cash flow assets maturing in the near term would be able to renew their debt upon maturity, in spite of drops in cash flow since the loans were originated.

Another implication of 2.5% 10-year Treasury yields is that the underwriting of commercial real estate cannot assume 3% inflation. Such an assumption simply makes no sense in a world where 10-year Treasury yields are 2.5%. Further, 20% returns will be almost impossible to achieve in a world of modest leverage and extremely low cap rates.

How do you protect yourself? You have to ask, “What is the absolute return I believe I need in a market like this?” We believe that the 10-year Treasury yields belong in the 4.5-5% range, and hence establish pricing from there. We may be wrong, and the bond market clearly disagrees, but the commodity market generally agrees with us.

Today’s investor must have clear views about the growth of the economy (jobs) and inflation over the next few years. In normal times, the range among sophisticated and knowledgeable investors on these variables is quite tight; today, the range is enormous. The fact that there is huge variability among potential bidders means that bids by intelligent investors can be 20-50% apart. Historically, while “micro” aspects of the property and the manager have generally determined the performance of an asset, macroeconomic considerations are of predominant importance today. If the economy adds 3 million jobs each year, and inflation is 5% per year over the next few years, it will overshadow whether one is a 10% more or less efficient manager. And, even the most efficient manager will be wiped out if there is deflation and more lost jobs. It is absolutely critical to have consistent and well thought-out views on both inflation and job growth.

As we predicted in April 2009, the bottoming of private pricing (peaking of cap rates) occurred about

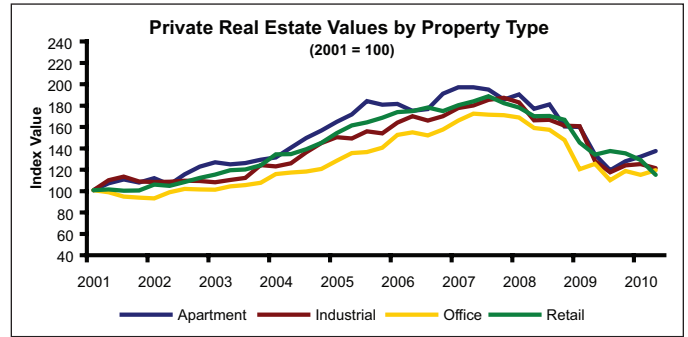


figure 8

15 months after REIT pricing bottomed in March 2009. This lag between public and private real estate pricing is consistent with the historic patterns of a 12-18-month lag in private pricing. Private real estate values have fallen, but not by as much as REIT pricing. The public market responds far earlier to both good and bad news than private real estate, so in the next few quarters, private real estate will go up.

Of course, some investors are probably investing simply because they have money which, if not invested, must go back to their capital sources. But this is not unique to the current times. In some cases, owners are selling because the asset no longer matches the owner’s skill set. In other cases, developers may be under sufficient distress as to lack the necessary capital to execute the required tenant improvements and capital expenditures. Another reason to sell today is if you need to recycle capital due to end dates of finite life funds. A final reason is that many of the partners are no longer viable entities to execute the original business plan. In any case, it is essential that asset owners ask themselves how bullish they are on future growth and inflation relative to their skill sets and capital needs, and on market pricing which anticipates a moderately robust economic recovery over the next three years.

It is interesting to note that as loans are retired, either via sale upon foreclosure, a fresh capital injection, or third-party refinancing, new lending has picked up. That is, “If you pay me what you owe, I can give you a new loan.”

The improved outlook for new CMBS issuance and the recent improvement in mortgage lending means that the upcoming refinance wave will resolve itself, much as we suggested two years ago. Specifically, huge chunks of land, unfinished developments, and broken condos will simply be written off and sold for \$0.05-\$0.25 on the dollar. On the other hand, cash-flow assets with good

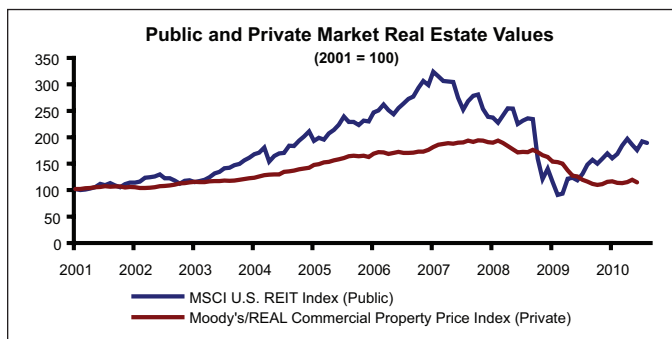


figure 7

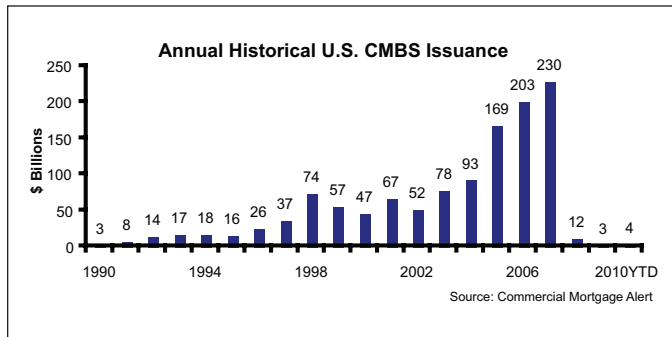


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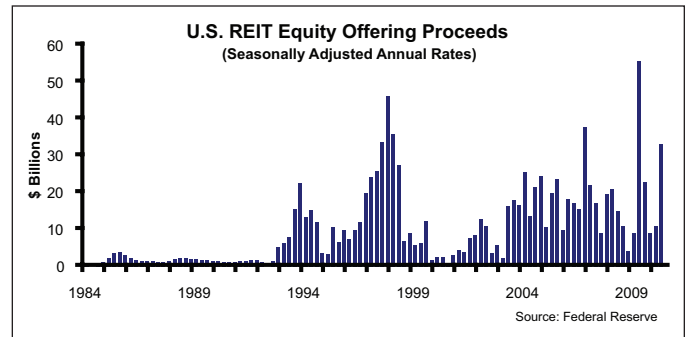


figure 10

interest coverage will be able to roll over maturing debt with a high degree of success, particularly with both long- and short-term interest rates at historic lows. These low interest rates allow owners to refinance with greater proceeds than otherwise possible, and also yield additional net of interest payment cash flow with which to service tenant improvements and capital expenditure.

Assets with coverage ratios of 0.8-1.1x will go through some type of restructuring or sale that requires additional equity capital. For owners of these properties, the day of reckoning for a poor capital structure is upon them.

Since periods of cheap and plentiful debt and equity are generally followed by periods of expensive and scarce debt and equity, at a minimum, when debt is plentiful and cheap, investors should keep abnormally high levels of equity reserves. This will offset the potential for future equity injections when capital markets normalize. Failure

to do so means that investors seriously mismatched asset and liability duration, increasing the potential that they will not survive difficult capital windows.

The real problem in the recent financial crisis was not excessive leverage, but rather excessive pricing, or more fundamentally the under-pricing of risk. As Miller-Modigliani noted long ago, whether it is called debt or equity matters little. What matters is whether the availability of debt and equity lead to the mispricing of assets relative to their true risk. The primary difference between mispricing associated with equity and that of debt is that equity prices adjust almost instantly, whereas the contractual nature of debt can be fought over for years at enormous legal drainage. But dumb pricing relative to the risk of the asset is what causes losses; the amount of debt merely determines how the losses associated with dumb pricing are allocated.

## About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For over 25 years he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry.

He also serves as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business, the University of Pennsylvania. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding coeditor of *The Wharton Real Estate Review*.

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