

Real Estate Outlook

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Overview

[Impetus for This Report](#)

- Commercial real estate investment has become extremely popular amongst institutional investors over the last decade as institutional investors embraced “alternative” investments.
- This made sense in the face of low expected returns for public markets and investors’ never ending need to find diversified risk exposures, income streams, and overall protection against long term inflation.
- What did not make sense however, were the increasing levels of leverage and seemingly endless tolerance for higher real estate prices on the part of investors and their associated investment managers. This propensity to embrace risk could very well have set off a decline in commercial real estate without even taking into consideration a “great recession” type of environment.
- Needless to say, we have seen a strong recession, an implosion in credit markets, and associated declines in virtually every risky asset class on a global basis, leading investors to seek liquidity wherever possible to meet spending needs.
- So what we have on our hands is a perfect storm of too much leverage, not enough credit, and investors running for the exits, while at the same time real estate prices are falling.
- The question of course is what to do? Buy, sell, hold, etc.?

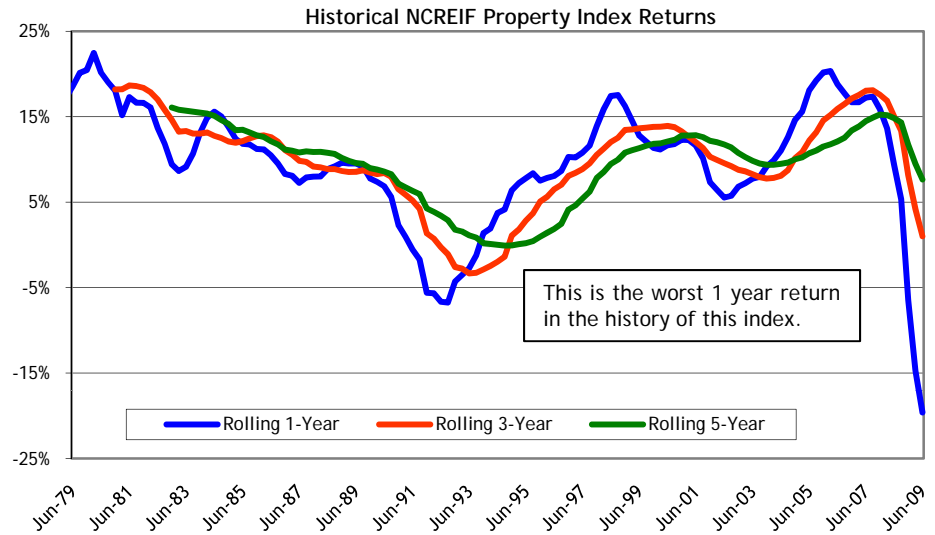
[Our Response](#)

- An examination of recent behavior in commercial real estate and their associated credit markets.
- An analysis of whether institutional investors have been led astray by these strategies, or if real estate is simply behaving as one would expect given the current macroeconomic and capital markets environment.
- A forward looking analysis of prospective returns for this asset class based on long term valuation metrics.
- A search for leading indicators to guide near term expectations, including a look at public real estate (REIT) markets.
- An analysis of issues facing real estate managers and opportunities that may result from the current environment.
- Recommendations for those currently allocated to real estate, as well as those looking to make new strategic allocations.

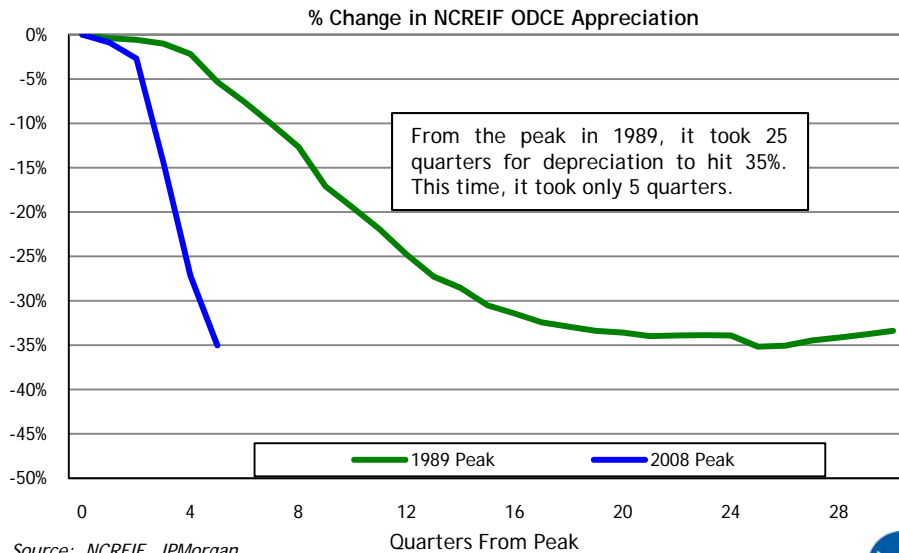


Unprecedented Decline in Private Real Estate

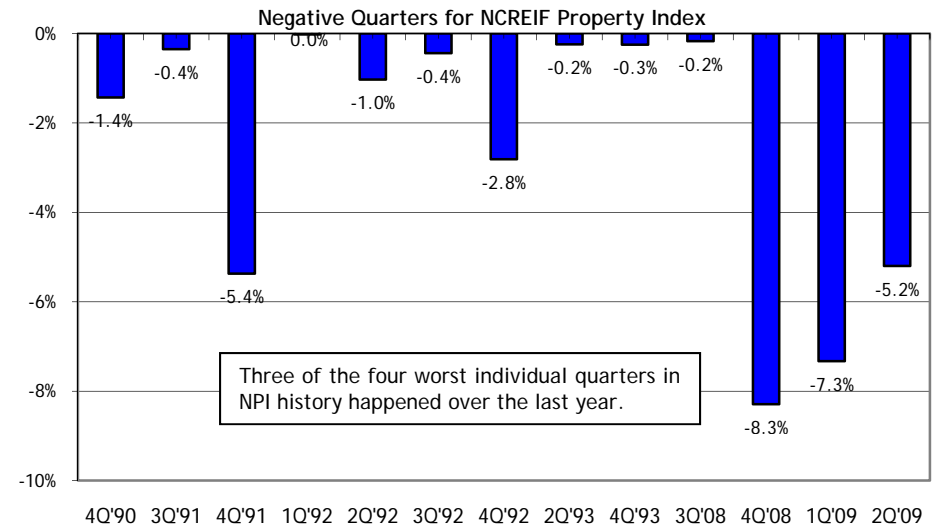
- One of the primary reasons real estate is at the forefront of investors' minds is the strong declines experienced over the last year.
- In fact, recent returns have been some of the worst in the history of the NCREIF index, both in terms of recent quarters and the last one year period.
- These declines are being seen in spite of returns being based on appraisal value. This is leading investors to greater concern as private real estate was often considered to be less sensitive to market fluctuations due to the illiquid nature of this asset class.
- In all fairness to private real estate, the public market for real estate (REITs) is down more than 40% over the last year through June.



Source: NCREIF (National Council of Real Estate Investment Fiduciaries)



Source: NCREIF, JPMorgan



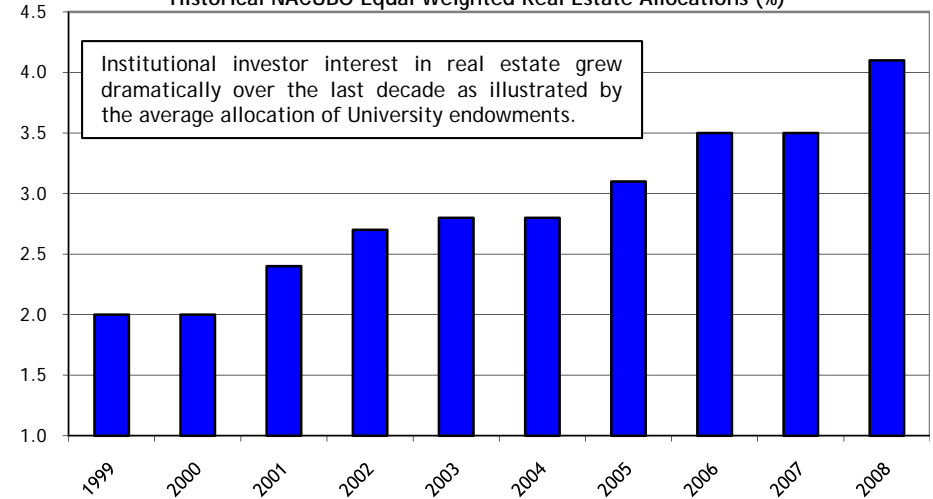
Source: NCREIF



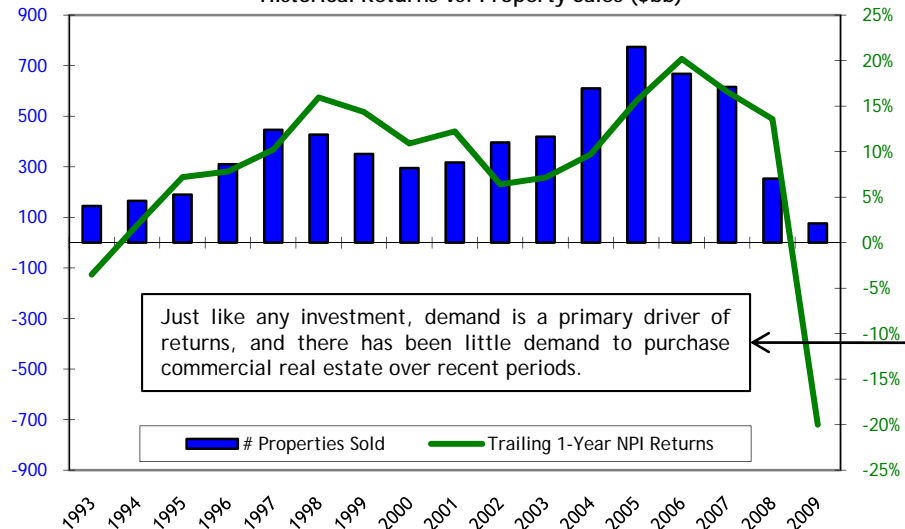
Recent History of Real Estate

- In the face of historically high equity valuations and relatively low credit spreads over the last decade (or the “low return environment”), it is no surprise to have seen investors piling into commercial real estate.
- It is due to increasing real estate allocations that prices moved so high. Easy credit and accommodative lending practices only served to enhance this process.
- We can clearly see how this increased investor demand affected returns. As transaction volumes went up, so did prices. The caveat of course was the availability of credit (or CMBS) to finance these activities.
- So when credit markets crashed, the momentum of this asset class came to an abrupt halt.

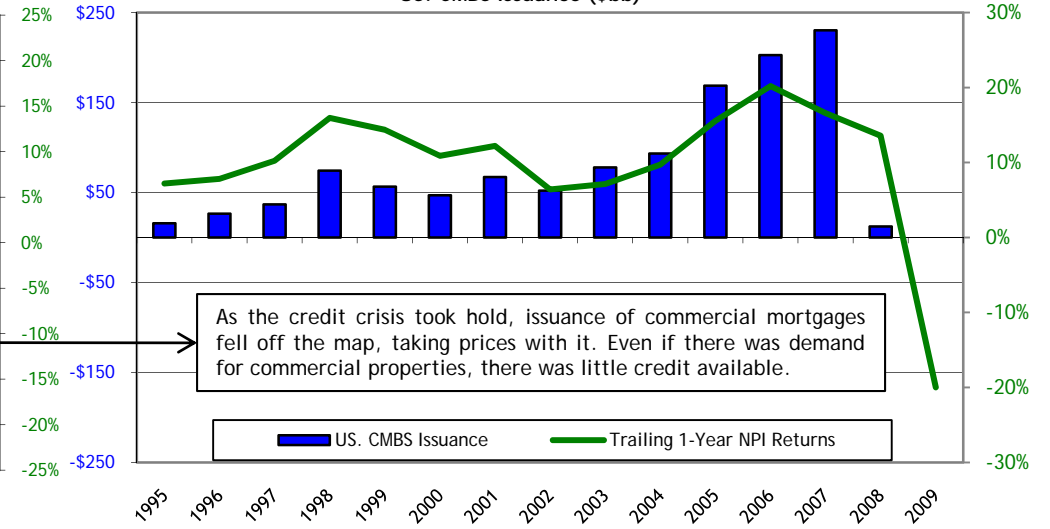
Historical NACUBO Equal Weighted Real Estate Allocations (%)



Historical Returns vs. Property Sales (\$bb)

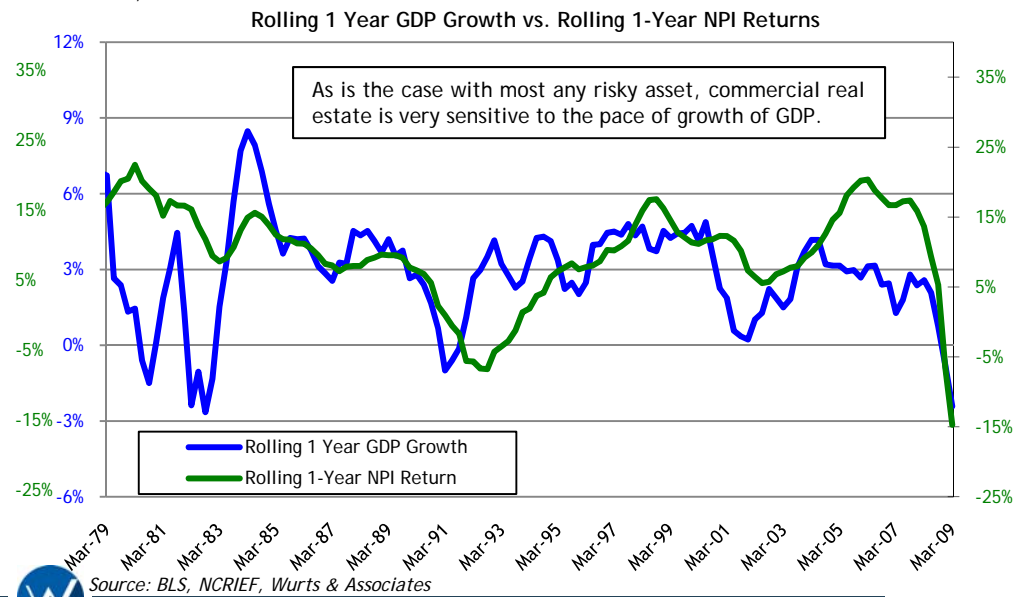
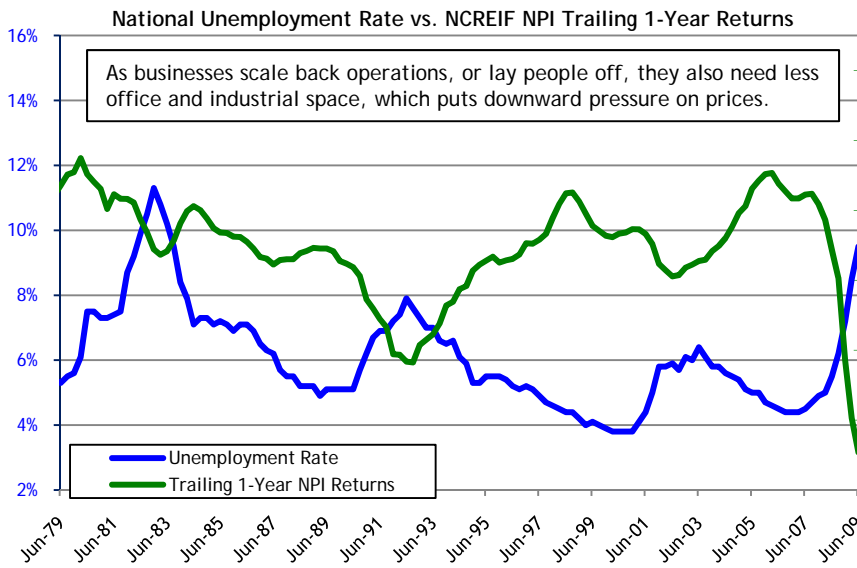
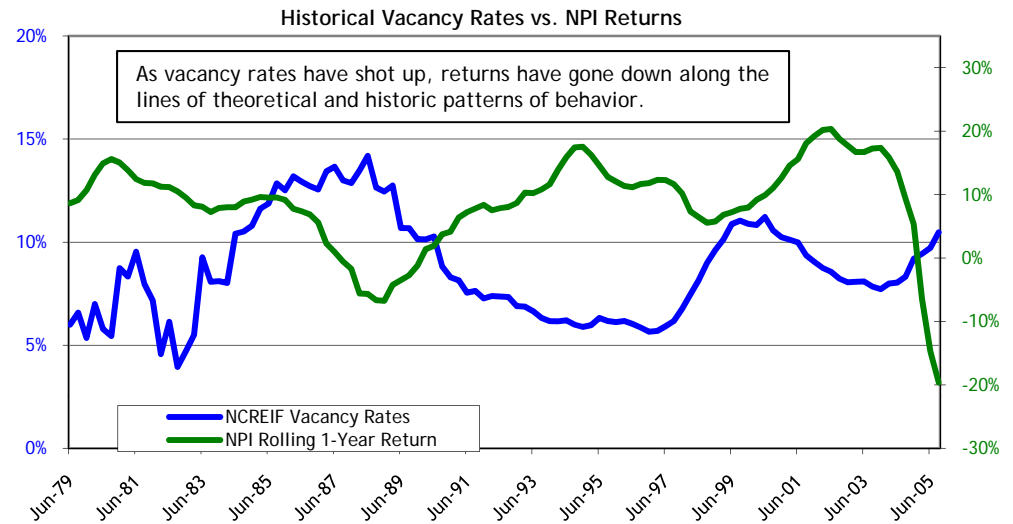


US. CMBS Issuance (\$bb)



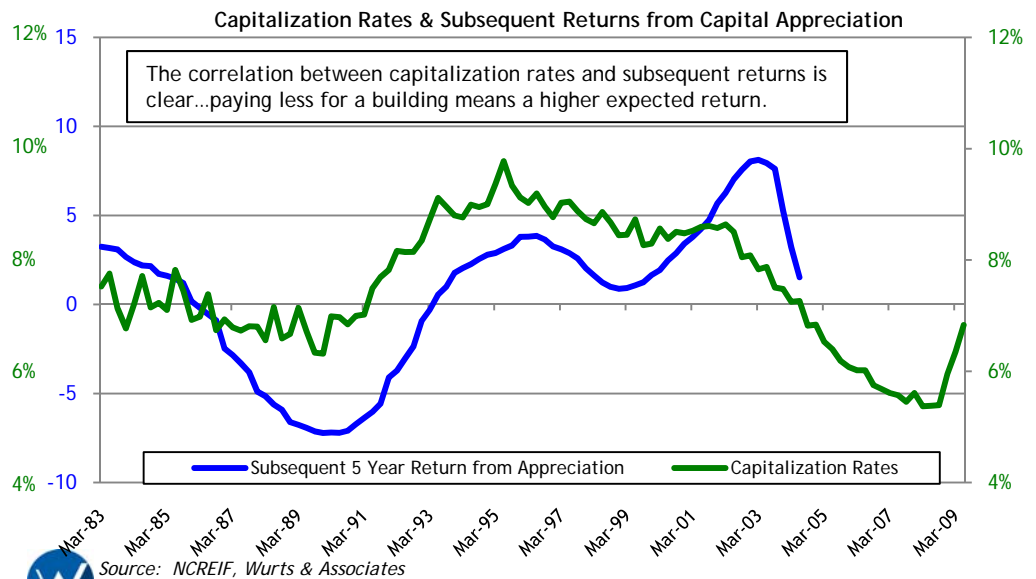
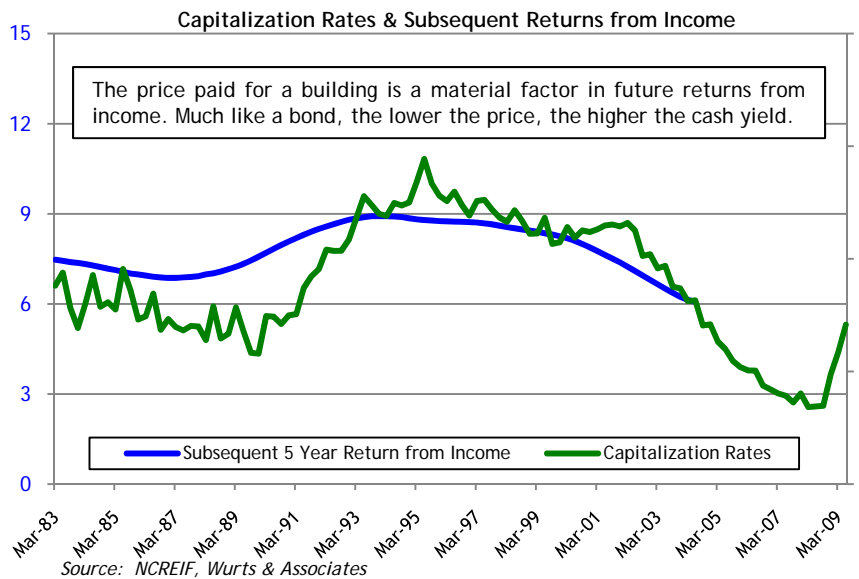
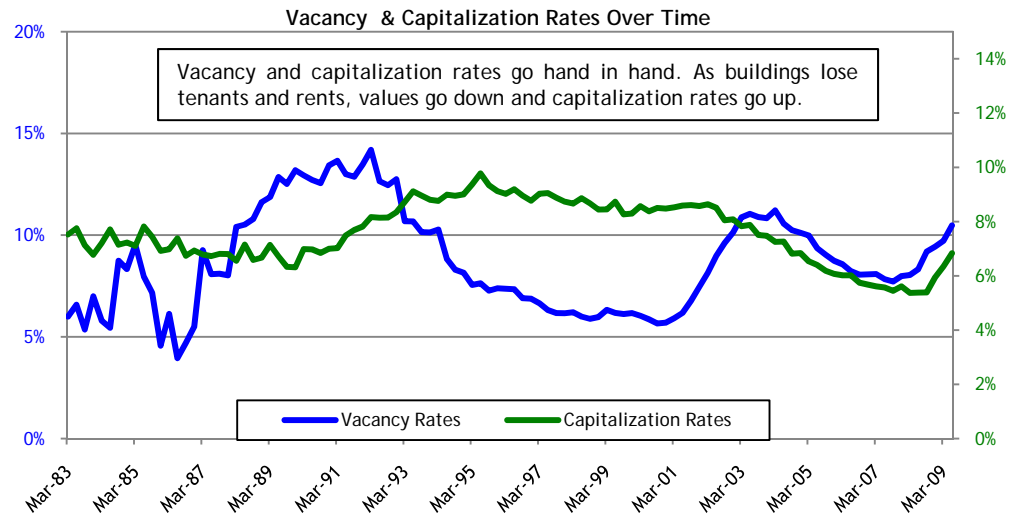
Like it or Not, This is How Real Estate is Supposed to Behave

- The whole category of “alternative” investments gained popularity over the last decade due to their purportedly uncorrelated returns to other major asset classes.
- Although this is somewhat true during normal times, the fact of the matter is real estate is just as sensitive to macroeconomic factors as are equities or fixed income.
- Expecting real estate to remain unaffected during an economic downturn is simply not a realistic expectation, as this asset class is very sensitive to the unemployment rate, GDP growth, and vacancy rates.
- So even though it is unpleasant to see double digit declines, this behavior is not unexpected given the macroeconomic environment.



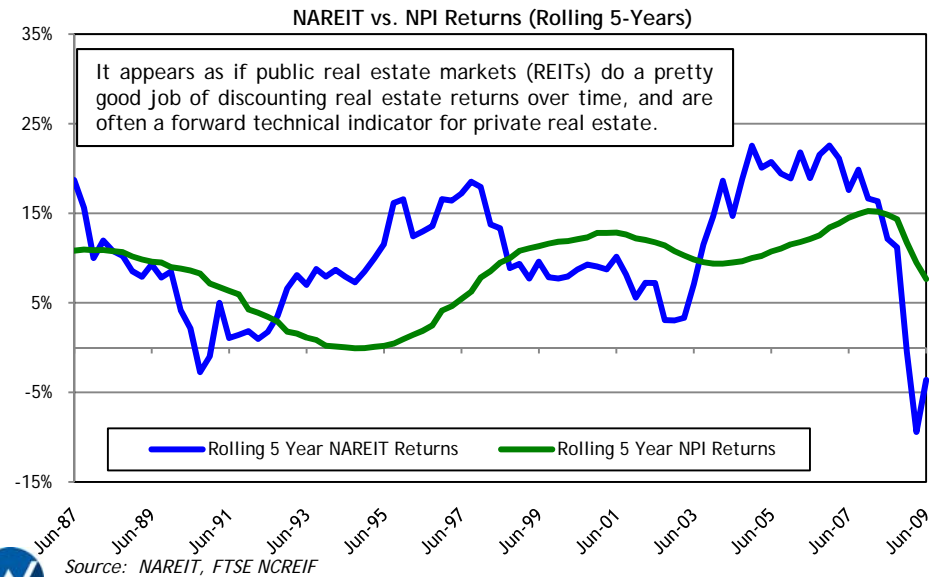
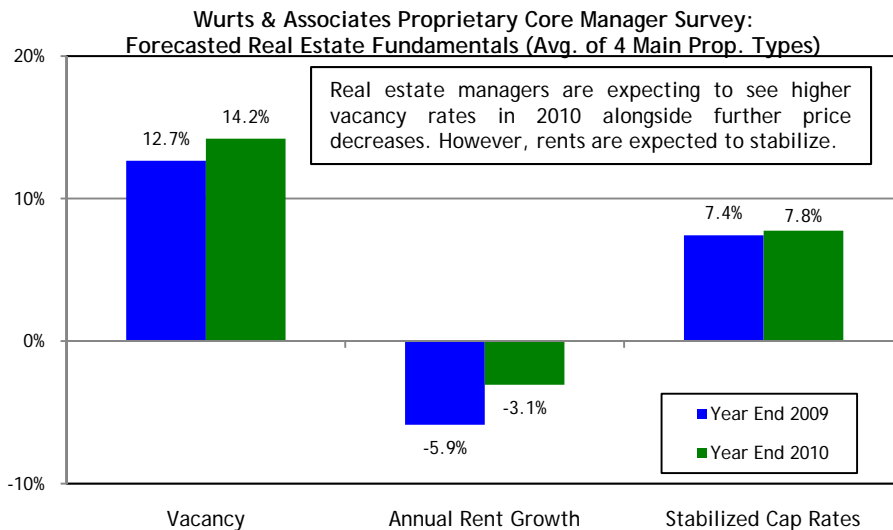
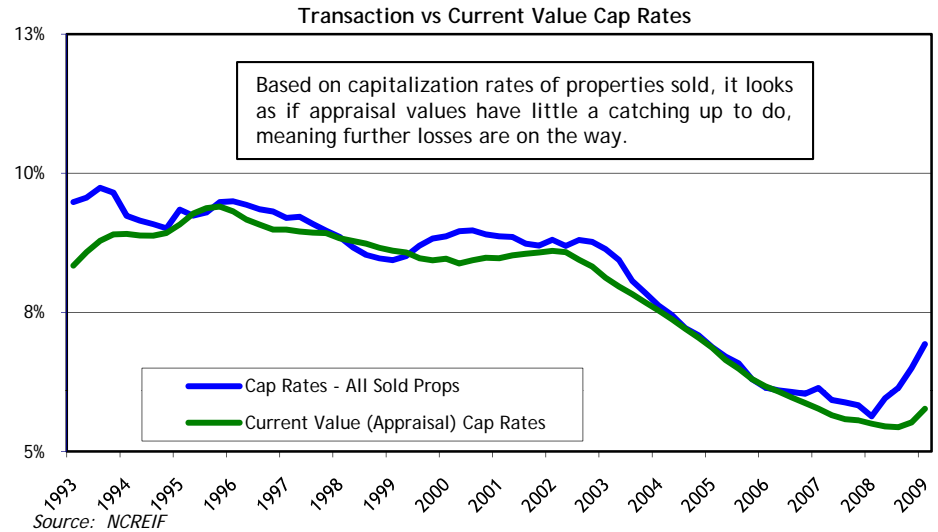
Stepping Back From the Fray and Looking Forward

- Although recent returns have been poor, they have made real estate investments more attractive than they were just one year ago.
- As we can see over time, it is normal for vacancy rates to drive capitalization rates (or building prices). So as vacancy rates have gone up in the face of rising unemployment, prices have gone down.
- The good news here is capitalization rates have been shown to provide solid predictive value for future returns from price appreciation and income.
- Though real estate has seen more attractive days, there is good reason to believe prospective long term returns are trending upwards as cap rates increase.



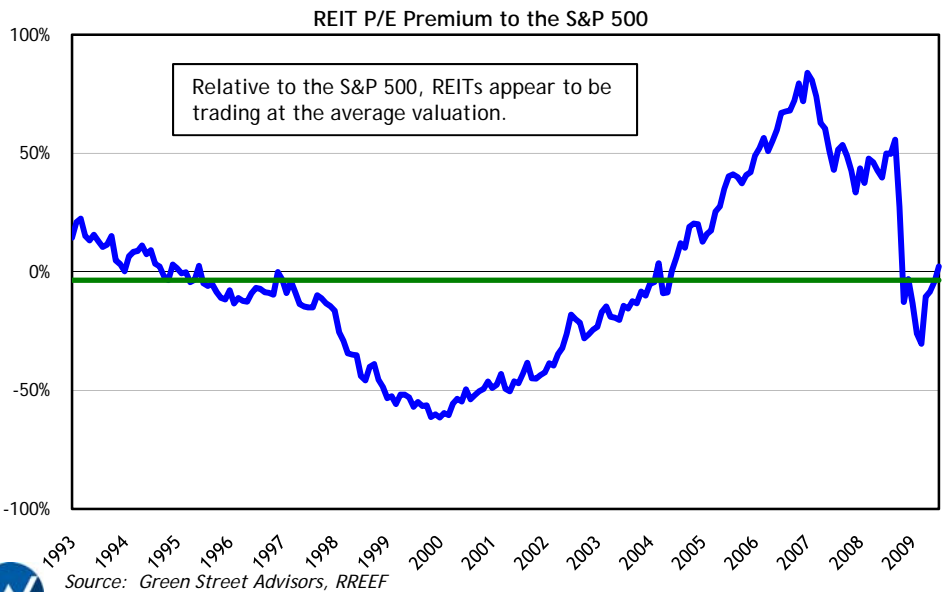
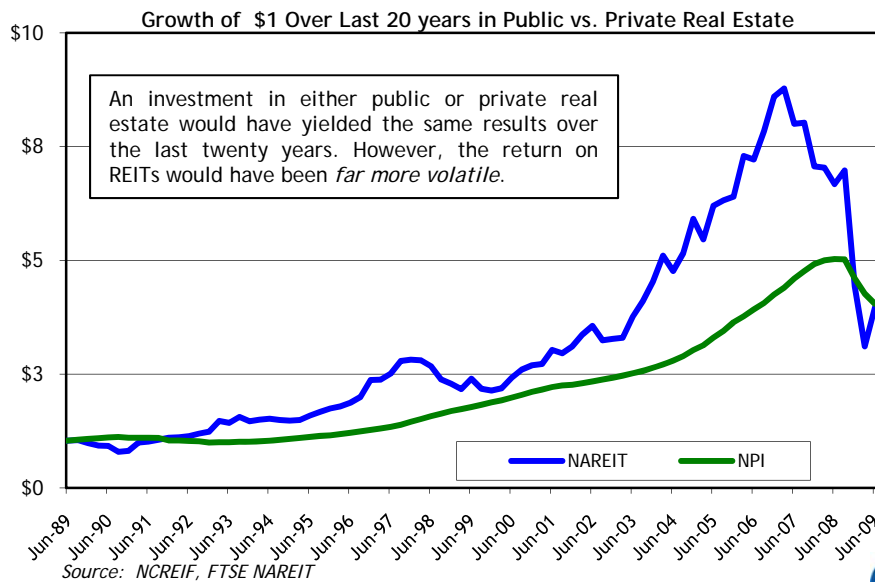
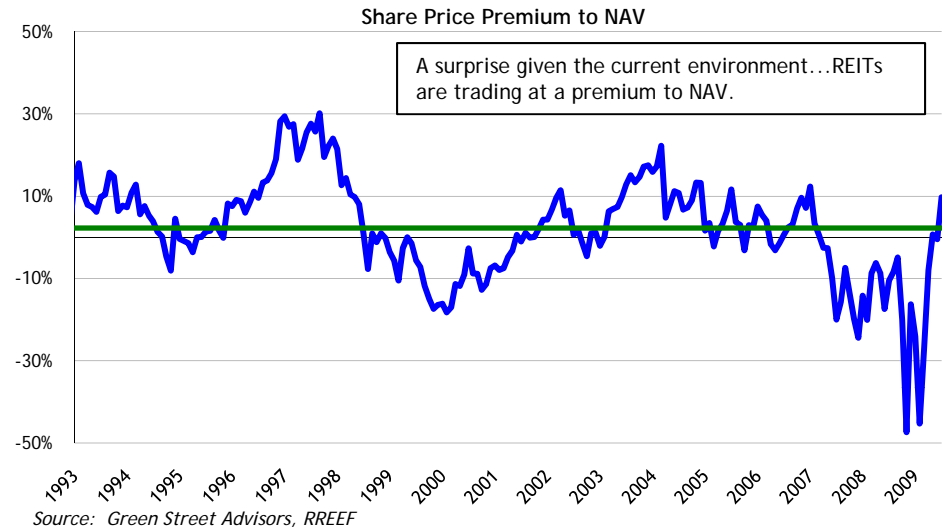
Are There Any Leading Indicators for Private Real Estate?

- Well the answer to this question is yes. There are some things we can look at to get an idea of what may come in the near term for real estate.
- Most notably, we can look at the transaction rates for properties which currently seem to be happening at higher capitalization rates than current appraised value. This means losses to price appreciation are on the way.
- We can also look at public real estate markets which have yet to indicate an upward trend on a technical basis.
- Another tool is to survey managers to determine their expectations for key aspects of the private real estate market, and it appears they foresee weakness next year.
- So for the time being further losses are likely.



Key Considerations for Public Real Estate (REITs)

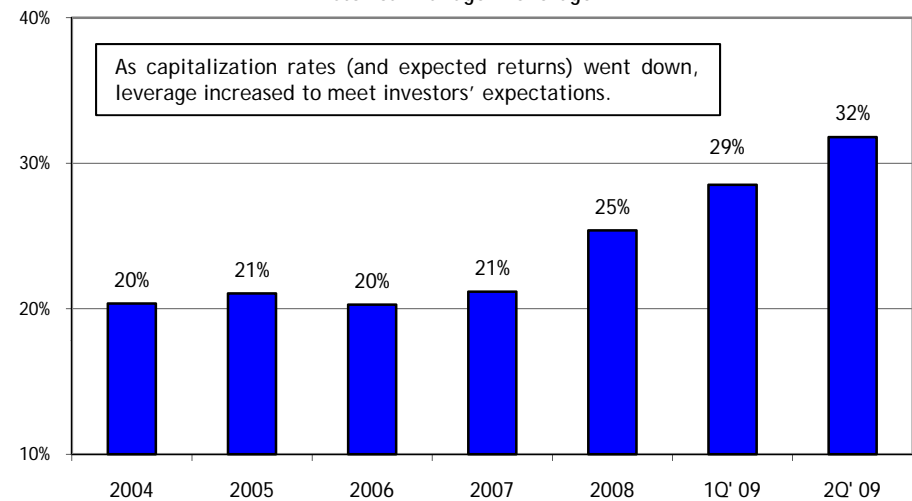
- Although REITs are traded just like stocks and tend to have a commensurate level of volatility, they are supposed to ultimately reflect the performance of their underlying assets - real estate. This appears to be the case over time.
- The problem with REITs however, is they are extraordinarily more volatile than private real estate, meaning their risk adjusted returns are far less attractive and ongoing maintenance is more involved (i.e., rebalancing).
- Nonetheless, in the current environment REITs appear to be trading at approximately historic average valuations with respect to their premium to net asset value (NAV) as well as their PE ratio relative to the S&P 500.
- Still, the volatility in REITs is most worrisome.



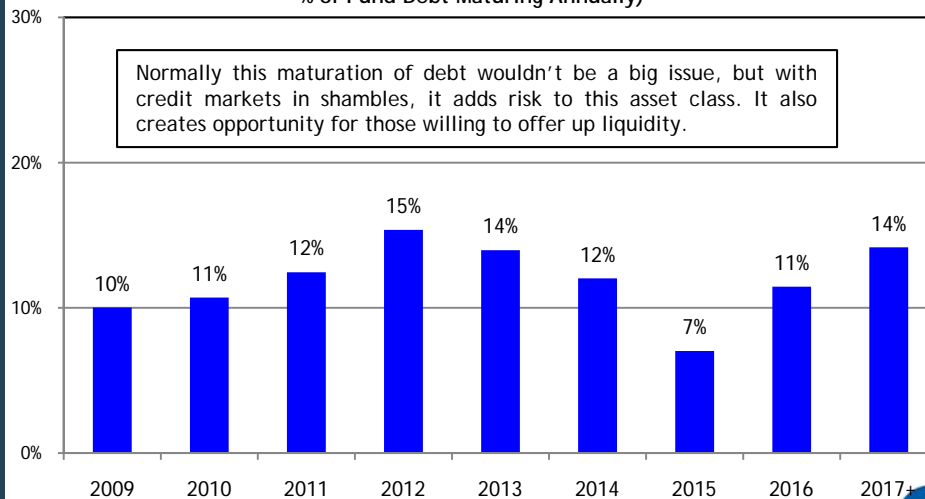
Current Issues Facing Core Real Estate Managers

- From an operational point of view, core real estate managers are collectively seeing some of the worst conditions possible.
- First and foremost, leverage had been steadily increasing over the last five years as investors sought increasingly higher returns on decreasingly low capitalization rates. This has only bolstered the asset class' sensitivity to market downturns.
- Second, institutional investors are in the process of rebalancing their portfolios, which is putting heavy pressure on managers to offer up liquidity, possibly forcing them to sell properties in one of the least liquid environments possible.
- On top of these factors, a significant amount of debt is coming due over the next several years. These loans will either need to be refinanced or properties will need to be sold.
- This is not necessarily bad news for long term investors.

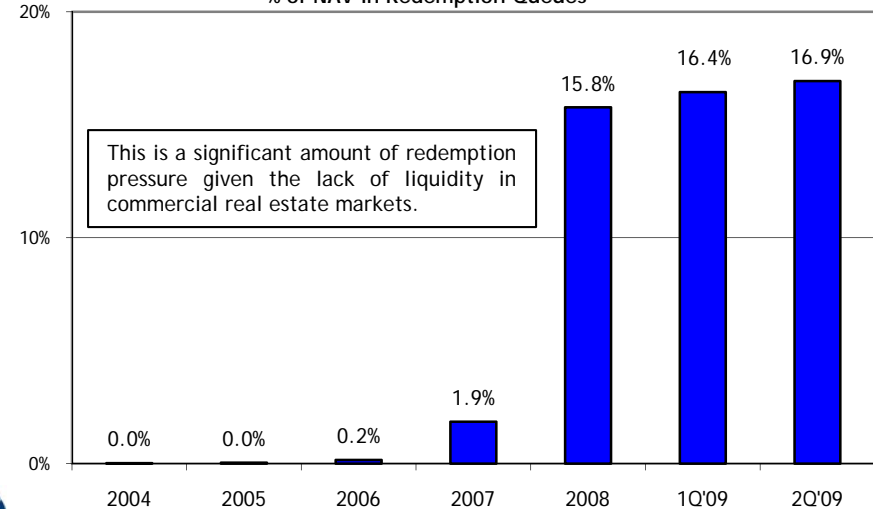
Wurts & Associates Proprietary Core Manager Survey:
Historical Manager Leverage



Wurts & Associates Proprietary Core Manager Survey:
% of Fund Debt Maturing Annually

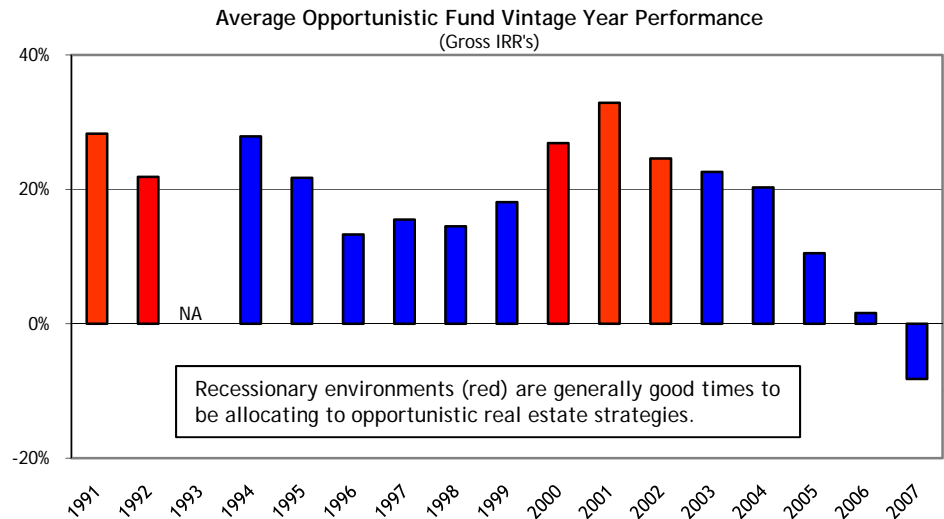


Wurts & Associates Proprietary Core Manager Survey:
% of NAV in Redemption Queues



Opportunities Within Real Estate

- Anytime private and illiquid strategies are involved, it is important to be willing to stand apart from the crowd and allocate to strategies when others are not.
- Historically speaking, recessionary environments have been a good time to allocate to opportunistic real estate. Given current price weakness, pending investor redemptions, and even managers' own forecasts, there may very well be a "buyers" market for commercial real estate on the horizon.
- Given the massive amount of leverage undertaken over recent years, now may be an attractive time to allocate to debt-related strategies as firms are forced to refinance.
- Finally, let's not forget real estate is good at producing income, and most managers seem to expect strong cash flows over the coming periods.



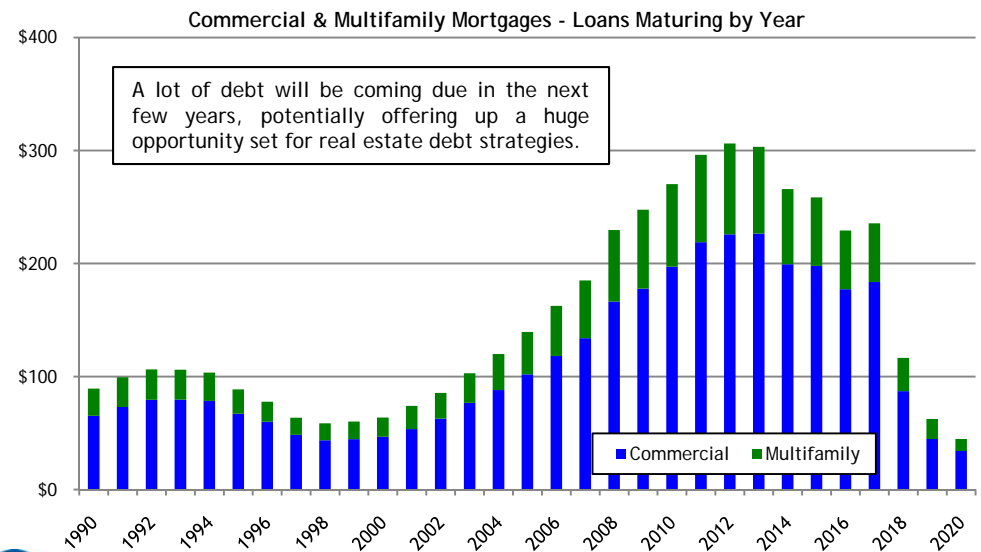
Source: NCREIF, Townsend, Thea Hahn, David Geltner and Nori Gerardo-Lietz

Wurts Proprietary Survey: Manager Forecasts For Core Real Estate

5 Years (2009-2013)			
	Income	Apprec.	Total Return
Average:	7.4%	-2.6%	4.7%
High:	7.6%	3.0%	10.0%
Low:	7.0%	-9.2%	-1.8%

10 Years (2009-2018)			
	Income	Apprec.	Total Return
Average:	7.3%	0.3%	7.5%
High:	7.8%	3.0%	10.0%
Low:	6.0%	-1.8%	4.2%
#obs:	6	6	6

*Note: *Total Real Estate AUM of managers surveyed: \$12.5 billion



Source: Federal Reserve Foresight Analytics, Invesco Real Estate



Concluding Thoughts

Strategic Implications of Current Real Estate Environment

- Commercial real estate, both public and private is behaving exactly as expected given the current macroeconomic and capital markets environment.
- Now is quite likely about the worst time to be redeeming from this asset class due to weak pricing and lack of liquidity.
- Of course we understand the need to follow portfolio rebalancing guidelines, but due to the illiquid nature of this asset class and the timing of cash flows, rebalancing is more complicated and should be considered differently than a public market investment.
- As a general rule of thumb, it is wise to avoid selling assets during times of excessive selling pressure and lack of liquidity.
- Going forward, long term return expectations for commercial real estate are moving upwards, which is the silver lining in the story.
- However, research does indicate further weakness is in store for real estate investors over the near term.
- With pending liquidation pressure alongside economic decline, now may be an ideal time to be buying, not selling.
- Unique circumstances in credit markets alongside near term refinancing activity indicate an opportunity may exist.

Broad Recommendations

- If possible, avoid liquidating real estate for the time being. Consider real estate's position within the overall portfolio not necessarily in today's value, but in the context of what may happen by the time liquidity is actually realized down the road.
- Slowly allocate to real estate strategies in the next year or two to take advantage of other investors' liquidations and falling prices.
- Opportunistic and debt related managers should be allocated to on a strategic basis over the next several years.
- Most importantly, keep an eye towards the long term, which is where we gain our best predictive value.

