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How to survive, profit from possible downturn in RE

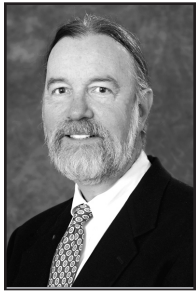
Unfortunately, for commercial real estate, several dominoes are starting to fall. What started as a bursting of the housing bubble in 2006 has expanded to severely restrict credit cost and availability. It is now clear this will slow down the U.S. economy.

The housing downturn has created two significant headwinds for the economy (and commercial real estate). As housing values drop, the "wealth effect" from rising home values is reversing into a "poverty effect," causing households to increase savings and reduce spending. Given that consumer spending is approximately 70 percent of the overall economy, this negative growth in spending is leading the U.S. economy into recession. Many economists fear this recession could be more severe and prolonged because of the implosion of mortgage debt markets. This could precipitate an asset bust like that which occurred during the savings-and-loan crisis of the late 1980s. As in that era, mortgage loans – the lifeblood of real estate – are now becoming much more difficult to get. According to our analysis, the same underlying forces that have caused the housing crisis (massive pools of poorly underwritten mortgage debt) may play out in commercial real estate over the next two to three years.

A logarithmic run-up in values (and subsequent crash) seems to be a predictable part of every real estate cycle. As shown on Chart 1, cap rates fell from the late 1970s and into the mid-1980s, coincident with the entry of S&Ls into the commercial lending market. As S&Ls pumped more mortgage money into real estate, values began to climb. A positive feedback loop was created as lenders "piled in," chasing rising values and falling default rates. Once values reached an unsustainable peak, lenders became restrictive and the feedback loop worked in reverse. With mortgages cut back, defaults spiked, and busted S&Ls were forced to fire-sale properties on a massive scale. Over a four-year period (1989-1993), overall cap rates rose quickly, adding 230 basis points – a 30 percent drop in value. The recession of 1990-1991 undermined real estate cash flow, also helping cap rates to rise.

After the crash, mortgage lenders returned to real estate, adding liquidity slowly but surely for almost a decade (1993-2002). Recently (2002-2007) the commercial mortgage-backed securities market added a massive jolt of mortgage liquidity (like the S&Ls before them).

Accelerated mortgage liquidity was pumped into the system following the unprecedented cuts to the federal funds rates



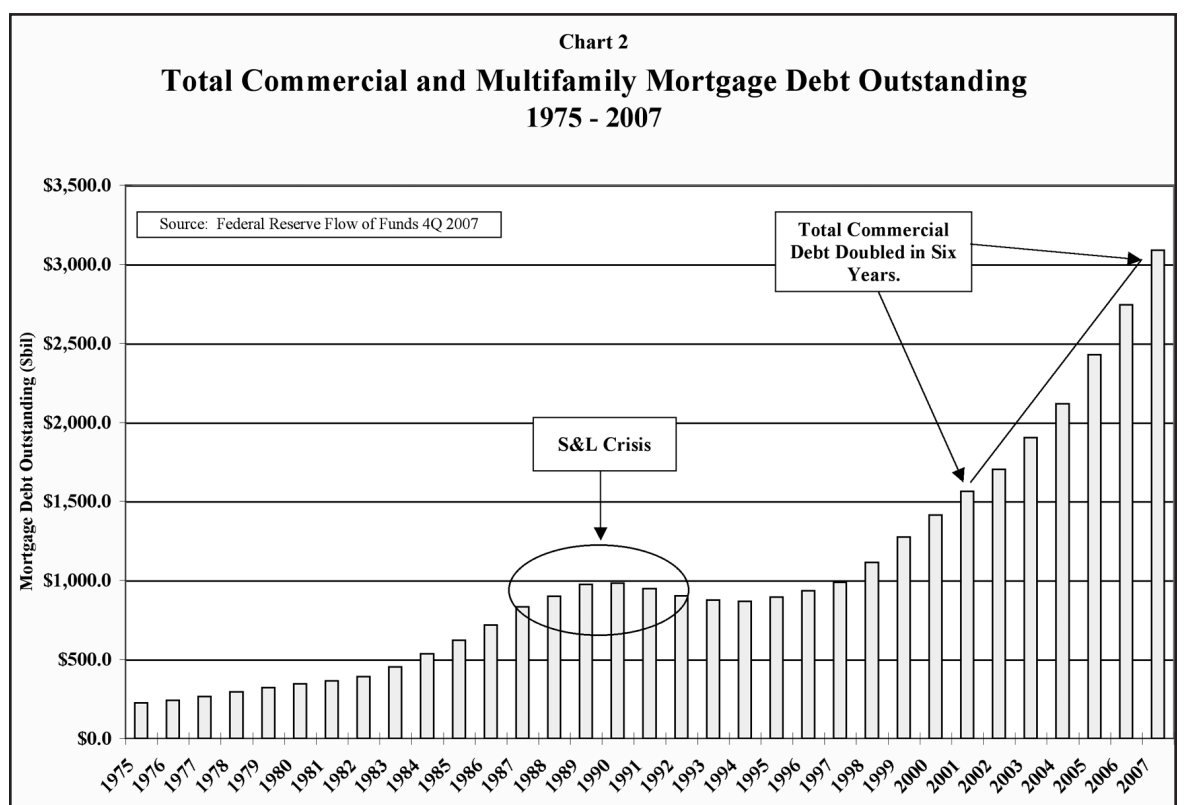
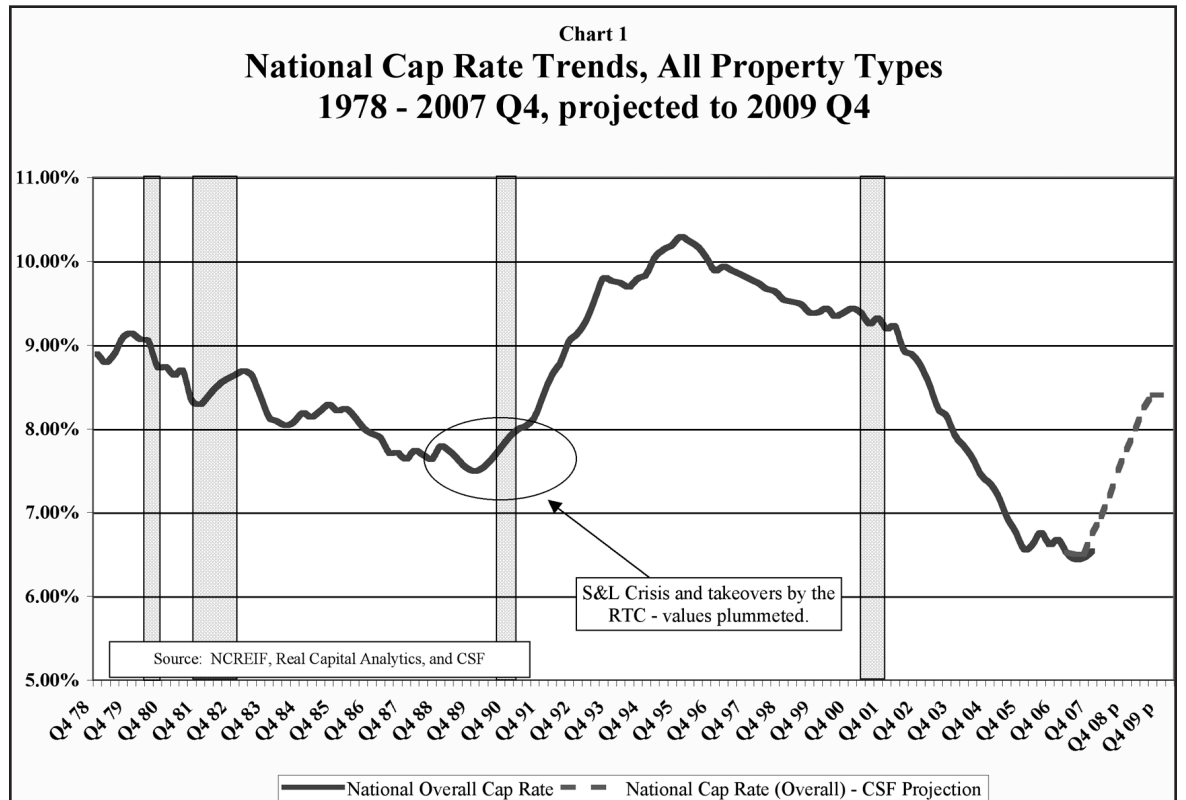
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between 2001 and 2003. As shown on Chart 2, commercial mortgage debt outstanding took over 200 years to reach \$1.5 trillion. Then, in a mere six years, commercial mortgage debt doubled to more than \$3 trillion by

2007!

Our analysis demonstrates a very high correlation between mortgage liquidity and values, with values driven up as lending rises (typically coupled with deteriorating lending standards). The rise in lending was precipitated from Wall Street CMBS issuance. The system worked only too well. At the end of 2007, there was \$776.6 billion in outstanding CMBS mortgage debt – 25.2 percent of the total commercial mortgage debt market. Leverage levels increased (85 percent loan-to-values based on future pro forma values were not uncommon), and assets values spiked. In our view, too much cash was chasing too few deals, precipitating an "unstable equilibrium." This is graphically illustrated on Chart 1. As more and more mortgage money became available, cap rates began a steep drop to historic lows, finally cresting by mid-2007.

Unfortunately, the 2006-2007 vintage loans (from both conduit and portfolio lenders) were aggressively underwritten on optimistic assumptions. If the economy stalls, many of these loans will be under water, as optimistic pro forma rents fail to materialize. Lenders, already aware of this, have significantly tightened underwriting standards, cutting loan dollars, and raising mortgage spreads. In fact, for the first time since their creation, no CMBS bonds were issued in January 2008. Commercial mortgage defaults are already rising, and rents – particularly in markets and sectors that depend on financial services – are flat to down. Our concern is that commercial real estate values will fall further, as cash flows deteriorate during a recession and cap rates rise. Unfortunately, the positive feedback loop works in reverse, too. Without the lifeblood of cheap, abundant mortgages, commercial real estate values are exposed and likely to fall. As shown on Chart 1, there is initial evidence of this; by early 2008, cap rates are already trending higher and we project they will rise until 2010.



What Can a Commercial Real Estate Investor Do?

In times of falling liquidity and recession, the cliché of "cash is king" should become "cash is emperor." As observers of long-term real estate cycles, we saw classic signs of a liquidity bubble as loan quotes became the most aggressive we had seen in 20 years. These factors pointed to an unsustainable peak in commercial real estate values. In 2006 and 2007, we sold most of our commercial real estate portfolio and converted to cash. Although values are down slightly, it is not too late to sell now and raise cash.

Investors need to act quickly because selling is becoming more difficult (due to rising

in cap rates and the difficulty obtaining financing). This means that sellers must be realistic regarding how the market sees values and not fool themselves. They must be willing to hit the bid. If investors are not willing to sell, the alternative is to secure five- to seven-year financing before rates rise and lenders become excessively conservative.

For investors with cash, there will emerge huge buying opportunities for distressed real estate. The opportunities may take two to three years before values hit bottom and market fundamentals improve again. In the meantime, investors should stay liquid to take advantage of this real estate opportunity (2008-2010). If the downturn

happens, don't despair; even in bad markets, hardworking, smart players always emerge victorious. Success is just making certain you're one of the winners. For us, having plenty of cash is not enough; we are looking for smart, capable operating partners to help us expand as commercial real estate opportunities unfold.

In conclusion, in order to survive, and profit from, a downturn in commercial real estate, investors should consider:

1. Going to cash (to buy later).
2. Refinancing assets now (before rates rise and loan dollars fall).
3. Micromanage assets tightly and lease aggressively, keeping a tight rein on expenses and cash flow.▲