

Crossing

We have journeyed many roads over the last few quarters, taken part in many diversions, and had many ups and downs (mostly downs). Now on the cusp of 2009, we find ourselves standing at the edge, peering across the great unknown. Getting to the other side of this financial situation appears more daunting than any experienced in recent history. The commercial real estate market looks on in fear: It is the year of the great divide.

We survived stagflation in the 1970s. We made it through the savings and loan crisis in the 1980s. We dealt with the commercial real estate debacles of the early 1990s, the dot-com bust in 2000, and the terrorist attacks in 2001. We had a handle — or so we thought — on the housing bubble that inflated over the last few years, and when the bubble began to lose air, we were convinced that the difficulties were primarily local and within our control. We have worked our way through several recessions during the last few decades, and we expected to see slower economic growth in 2008. But as recently as 2Q08, when gross domestic product growth was a couple percentage points higher than expected, we thought we averted another recession, or at least a major one.

Today, we are uncertain, afraid, and angry about the market: Our confidence in investing has been shaken to its core. We are cornered by a situation that will not be easy to resolve. Each step we take toward the future sets the tenor for our journey to the other side of this great divide, which we hope will provide stable ground. How our

Kenneth P. Riggs, CCIM, CRE, MAI, is chief executive officer and president of Real Estate Research Corp., an independent commercial real estate investment market research, valuation, and consulting company in Chicago. Contact him at (312) 587-1900 or riggs@rerc.com.

perceptions, egos, and financial positions changed during 2008 — and did so in such an abrupt and unforgiving manner!

While most of us have been gutting out the credit crisis that evolved over the last year, it was still a major blow when Bear Stearns' house of cards began to fall in March and a knockdown punch when the federal government placed Fannie Mae and Freddie Mac into conservatorship in September. No one realized how close we were to seeing our entire financial system collapse: We were looking into the abyss.

The final etchings on the wall were a whirlwind of key banking and insurance company mergers, acquisitions, and takeovers. If that were not enough, the U.S. Congress approved and the president signed the Emergency Economic Stabilization Act in October 2008. The Treasury,

Federal Reserve, and Federal Deposit Insurance Corp. quickly began to implement the Troubled Asset Relief Program authorized under EESA, beginning with the infusion of additional capital into the banking system to make more credit available to investors. Although this is the most significant government intervention program in U.S. history, it is a necessary step, but by no stretch is it a silver bullet. The goals were to stop the bleeding, make credit available to lending institutions so businesses could continue to operate, and finally to begin stabilizing the markets in order to conquer the great divide between investor fear and confidence.

The Investment Terrain

To say the investment landscape has changed dramatically during the last few months is an understatement. Even former Federal Reserve Chairman Alan Greenspan has called this a “once-in-a-century credit tsunami.” The once-czar of the Federal Reserve finds himself on the hot seat for his past decisions or lack thereof by once idol-worshipping congressmen and senators. No reputation is beyond reproach in these desperate times. As a result of this situation and its impact on the U.S. and global economies, a recession is now unavoidable. The only questions remaining are how long, how deep, and to what degree the commercial property sectors will be affected.



Jan Greune/Getty Images

The year 2009 will not be for the faint of heart. The optimistic among us are hoping the recession will be short-lived and shallow — several quarters followed by slow but positive economic growth. Others are expecting a more significant event, but not as severe as the Great Depression. With an estimated \$2 trillion to \$3 trillion of wealth lost last year due to plummeting housing values and stock and retirement account losses, consumers are shell-shocked. Energy prices dropped greatly during fall 2008, but as business activity slows, consumers are worried about job losses. Government spending will be able to help, but state governments are strapped. With so much capital dedicated to stabilizing the financial system, new federal government assistance to individuals will be limited. Watch for little to no GDP growth for much of 2009, increased unemployment, flat consumer spending, and continued slow housing growth. However, interest rates will remain low and inflation should hold steady if oil prices remain moderate.

Assuming the recession does not reach the levels of 1981 and 1982, pent-up consumer demand is likely to increase in mid- to late 2009. This should ramp up business activity in 2010, but business taxes are likely to increase and the additional federal regulations imposed by EESA will slow borrowing and risk taking among business owners. Like it or not, the era of big government is back, and the price we will pay is protectionism and a slow-growing economy.

Navigating the Pass

For those of us accustomed to offering market forecasts for commercial real estate, this outlook is perhaps one of the most difficult to pin down. On one hand, commercial real estate, if not overleveraged, is poised to do relatively better than the alternative investment choices on a risk-adjusted basis, but that does not mean stellar performance: It means that you do not fall into the abyss. In general, the commercial real estate industry will escape the devastation, destruction, and total recasting seen in the financial markets. And although there will be no collapse, there will be some ugly workouts, many of which already are underway. In addition, repricing in certain property sectors and certain public real estate investment trusts will be extremely painful for owners and investors.

On the other hand, as unemployment increases and economic difficulties continue, the credit crisis will further affect the demand side of the equation for every commercial real estate sector until consumers regain confidence in the economy and business reverses its inability or unwill-

ingness to take on expansion. As a result, vacancies will continue to increase in 2009, repricing and price corrections will occur, capitalization rates will increase, and rents will remain flat, or in many cases, decline. Although this is not great news, the losses should not be nearly as severe as those with stocks or other asset classes. Unfortunately, that does not bring much comfort to already battle-fatigued investors.

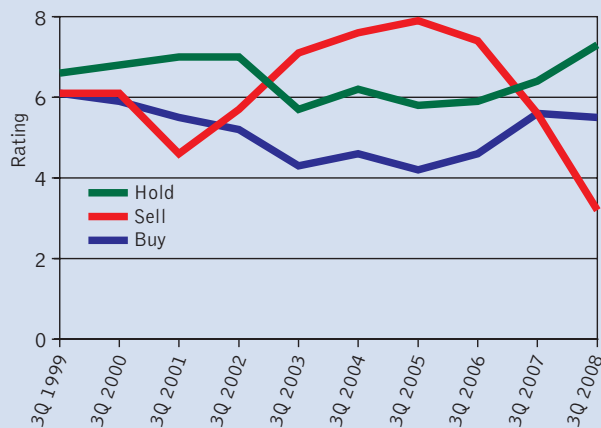
In a recent Real Estate Research Corp. survey, institutional respondents viewed the U.S. economy worse now than at any time since Sept. 11, 2001. The lack of credit availability is the biggest risk to the economy, followed by additional job losses and high oil prices, respondents said. More than 70 percent of them also feel the credit crisis

the Divide

Investors ponder how to bridge the gap between fear and confidence.

by Kenneth P. Riggs, CCIM, CRE, MAI

RERC Historical Buy, Sell, Hold Recommendations



Source: RERC

Institutional Investment Conditions, 3Q08

	INVESTMENT CONDITIONS			
	3Q 2008	2Q 2008	3Q 2007	3Q 2006
Office - CBD	4.9	5.7	5.9	5.9
Office - Suburban	3.8	4.6	5.5	5.8
Industrial - Warehouse	5.1	5.5	5.7	5.6
Industrial - R&D	3.9	4.7	5.5	5.2
Industrial - Flex	3.9	4.5	5.2	5.1
Retail - Regional Mall	3.9	4.2	4.6	4.3
Retail - Power Center	3.1	4.0	4.9	4.8
Retail - Neighborhood	4.1	4.8	5.1	5.4
Apartment	5.9	6.4	5.5	6.2
Hotel	3.9	4.0	5.4	4.6

Investment conditions rated on a scale of 1 = poor to 10 = excellent
Source: RERC Institutional Investment Survey

has worsened and that it will continue to hold back the economy for a year or more.

In a mixed-asset context, commercial real estate generally is much more stable than other investments. From a historical perspective, the strongest recommendation continues to be a general hold strategy, although this also may be a good time to buy (assuming you have money and the ability to gut-out some tough times ahead), particularly properties that face uncertain futures due to weak space fundamentals in specific U.S. regions.

It will take some time to conquer the divide between the fear we have about the economy and the confidence needed to continue to invest, whether as buyers or sellers. But despite the weakness in the market now and while we certainly have challenges, there always will be opportunities for those who study the fundamentals, invest wisely, and have realistic expectations.

Property Types in Perspective

A look at each property sector's projected performance provides insight into what 2009 may hold for commercial real estate.

Office. Compared to the repricing of the 1990s, the U.S. office market is reasonably positioned to survive the current economic downturn, primarily due to lack of over-

building in recent years and increased government demand for office space. However, with job losses in the financial-services industry and businesses canceling or deferring expansion plans in most office markets, net absorption will be quite low. Vacancy is expected to increase to about 15 percent in 2009, according to Torto Wheaton Research, with rental growth weak or negative in most markets. In addition, federal government expenditures associated with EESA will prompt much greater regulation, resulting in less business expansion. Like all property types, the office market faces a downward price correction and increasing cap rates, but compared to previous down cycles, fundamentals remain relatively strong and will provide some stability to the overall sector.

Investment conditions for central business district office properties dropped to a neutral position in late 2008, compared to a strong buy a year earlier. However, the suburban office market was rated as moderately underperforming in late 2008 as compared to a neutral view as recent as early 2008. Required office property cap rates increased during 2008 by 25 to 50 basis points. Expect office demand to decline in 2009 and pricing to deteriorate.

Industrial. Prior to the credit crisis, the

industrial sector was enjoying a long run of solid performance — a result of global and U.S. economic growth, global trade, and strong consumer spending. However, with a rapidly slowing world economy and the weakest consumer spending in nearly 20 years, demand for industrial warehouse space as a facilitator to the movement of goods has slowed dramatically. As a global recession takes hold, warehouse demand directly related to U.S. trade volume and manufacturing will be weak over the near to intermediate term. Negative absorption is expected to continue throughout 2009 and industrial availability will rise to approximately 12 percent, according to TWR. In addition, expect rental growth to turn negative in 2009 and remain under pressure until the U.S. economy and consumer spending improve.

Investment condition ratings for the industrial warehouse sector ended 2008 in neutral performance territory compared to a slight over-performance rating in 2007. However, industrial research and development and flex property sectors closed out the year slightly below neutral positions. The required cap rates for industrial property types increased 40 to 50 basis points over last year and are expected to continue in that direction in 2009.

In a mixed-asset context, commercial real estate generally is much more stable than other investments.

Retail. The retail sector's great run came to a screeching halt in 2008. With a declining housing market, the end of cheap credit, and increasing unemployment, consumers have finally clamped down on spending. With an economic recession, retailers are expecting the 2008 holiday sales season to be the weakest in nearly 20 years. Discretionary spending is not expected to improve in 2009. As a result, with the higher cost of capital, store closings, and retailer credit problems, net absorption of retail space is expected to decline and vacancies will continue to increase to approximately 9.5 percent in 2009, according to TWR. However, this is dependent on the strength of local and regional economies and housing markets. Retail rental growth is expected to continue to weaken in 2009 as vacancy rates and tenant credit problems increase.

Investment condition ratings have deteriorated for all retail property types during the last year and are expected to continue this trend in 2009 as consumer discretionary spending remains under significant pressure. Regional malls, power centers, and neighborhood/community centers gen-

erally had neutral performance positions a year ago, but at year-end 2008, regional malls have a moderate underperformance rating while power centers and neighborhood/community centers are moving into an underperformance phase for 2009. Required cap rates for the various retail property types increased throughout the year, 60 to 90 basis points higher than at the beginning of 2008. Although there may be some exceptions, such as in grocery-anchored retail centers, further repricing, increasing vacancy rates, and continued upward pressure on cap rates are expected.

Multifamily. Although apartment fundamentals remain reasonably healthy, the multifamily sector also will struggle in 2009. Uncertainties about Fannie Mae and Freddie Mac's long-term financing role continue. Perhaps more than with other commercial property types, government policy will play a critical role in the apartment market's performance. There is definite upside potential for the sector, given increasing demographic demand from typical apartment-dwelling cohorts and tighter

lending standards imposed on home buyers. However, clear downside potential to apartments also exists in the near term due to the overhang of shadow competition in the form of single-family homes and condominium units. While new apartment supply will continue to decline, it will outpace net absorption by a large enough margin to keep vacancy rates above 5 percent in 2009, according to TWR. Effective rental growth for the apartment sector over the next couple of years is expected to slow, although gradually improving in the intermediate to long term.

The apartment sector ended the year with the strongest buy position of all the major property sectors. In addition, the apartment sector is the only property type where the amount of investment return is higher than the amount of risk taken. However, required cap rates for this property type have increased 50 basis points during 2008. Apartment investors should expect downward pressure on prices to continue during the next year or two, along with upward pressure on cap rates, until housing-sector shadow space subsides.

Hospitality. Business and leisure travel began to decline in 2008 due to high energy costs, reduced airline capacity, and increased economic uncertainty. As travel slowed, hotel property fundamentals began to deteriorate as well. Although the weak U.S. dollar has buoyed hotel demand and room rates in gateway cities such as Miami, San Francisco, New York City, Boston, Orlando, Fla., and Los Angeles, demand is expected to shrink in these cities as the global economy weakens, much like it has diminished in the secondary and tertiary markets. Hotel fundamentals have continued their slow decline, posting negative results for occupancy and revenue per available room. RevPAR has not posted negative quarterly growth since 2Q93, according to Smith Travel Research, which also pegged hotel occupancy at 65.8 percent in 3Q08.

The good news for the lodging sector is that many hotel projects in the planning stages have been delayed, postponed, or canceled, although projects initiated before the credit disruption will come on line in 2009.

2009's 10 Most Promising Markets (on a relative basis)

Many dynamics typically influence commercial real estate investment conditions, but as we look to 2009, certain variables will have more influence than others. In the list of top 10 markets for 2009, the following factors were considered to determine which cities offered stability and growth potential in this particular economic downturn:

- not greatly affected by the credit crisis/financial markets or overzealous home prices;
- ample federal government facilities, large universities, military or defense/security sites, or noted healthcare institutions (or several of these industries);
- strong, stable industries, such as the agricultural industry in the Corn Belt or growth of research and technology industries versus weakness in the upper Midwest automotive industry or expected weakness in tourist areas; and
- strong employment.

Property fundamentals such as vacancy rates, prices, and capitalization rates of the 48 markets reported on in the *RERC/CCIM Investment Trends Quarterly* also were considered. Based on this research, the following cities may offer some of the best commercial real estate opportunities.

SOUTHWEST	MIDWEST	EAST COAST	SOUTHEAST
San Antonio	Pittsburgh	Boston	Oklahoma City
Austin, Texas	St. Louis	Washington, D.C.	Baton Rouge, La./
Dallas	Kansas City, Mo.		New Orleans

But if the recession is not severe or prolonged, occupancy declines should be sufficiently mild to allow hotels to maintain moderate average daily rates and pricing power, even while hotel performance remains under pressure until the economy improves.

The hotel sector received a moderately strong over-performance investment rating at year-end 2008 versus the neutral investment rating it received a year earlier. The sector's cap rates increased 60 to 70 basis points during the year, which is expected to continue through 2009, except for high-quality hotels in major markets.

Getting to the Other Side

At year-end 2008, the jury is still out as to whether the implementation of EESA and TARP will have the desired effect in the capital markets to help bridge the gap between investor fear and confidence.

Historical Return/Risk and Value/Price Ratings

	3Q 2008	2Q 2008	1Q 2008	4Q 2007	3Q 2007
Return vs. Risk					
Office	4.4	4.4	4.7	4.6	5.1
Industrial	5.0	4.7	5.6	5.2	5.3
Retail	3.4	3.9	4.1	4.3	4.4
Apartment	5.4	5.3	5.7	5.5	5.1
Hotel	4.1	4.0	4.5	4.0	4.7
Overall	4.2	4.2	4.6	4.7	4.7
Value vs. Price					
Office	4.3	4.5	4.3	4.4	4.7
Industrial	4.8	4.6	5.1	5.0	4.8
Retail	3.8	4.2	4.2	4.2	4.4
Apartment	4.6	4.8	5.1	4.9	4.6
Hotel	4.0	4.0	4.5	3.0	4.0
Overall	4.2	4.4	4.5	4.6	4.2
Ratings are based on a scale of 1 to 10, where 1 is poor and 10 is excellent. Source: RERC Institutional Investment Survey, 3Q 2008					

Legislative Outlook

The following issues may affect the commercial real estate industry this year.

TIC Securities

On Nov. 16, 2007, the Securities and Exchange Commission published the National Association of Realtors' request for an SEC exemption. This action would permit licensed real estate brokers or agents with substantial commercial real estate experience, such as CCIMs, to receive fees for tenancy-in-common securities transactions.

NAR continues to have positive discussions with the SEC to produce a favorable solution that will allow CCIMs and other commercial real estate practitioners to receive compensation for brokerage of TIC securities. Although a timeline has not been determined, the SEC's decision most likely will occur after President Obama settles into office. CCIM Institute is confident that a favorable decision will be made in the near future.

Small-Business Health Coverage

Rising costs and shrinking profit margins have made it increasingly difficult for small businesses and self-employed individuals to afford health insurance. More than 350,000 real estate practitioners are uninsured, according to NAR.

In 2008, NAR and the institute supported small-business health plan legislation, which would have permitted real estate practitioners to negotiate for health insurance coverage through their association, thus creating a larger pool of participants. However, shifts in congressional leadership made it increasingly unlikely for this legislation to become law.

Later in 2008, NAR reached a compromise through negotiations with Senate leadership by the introduction of the Small Business Health Options Program. SHOP would encourage states to reform small-group insurance regulations through tax

incentives. SHOP would create a nationwide insurance purchasing pool for small businesses and the self-employed as well as provide tax credits to self-employed individuals and small-business employers who offer health insurance to their workers.

NAR and the institute will continue to build upon the progress made last year and plan to work with the Obama administration and Congress to enact a small-business health care plan that would give commercial real estate practitioners nationwide access to affordable health insurance.

Energy/Climate Change

A number of studies have linked the rising global temperature to greenhouse gas emissions. These reports, combined with the desire to lessen U.S. dependence upon foreign oil, have created a groundswell for proposals dealing with energy conservation and reducing emissions, including carbon dioxide. These factors make it likely that energy and climate change will be central issues for Congress and President Obama during the 2009 legislative session.

The institute supports the development of voluntary standards for reducing greenhouse gas emissions for new construction and existing properties. The institute also supports using sustainable materials in building construction, as well as programs that reduce the carbon footprint of real estate assets. However, requirements to retrofit existing buildings must take into consideration the needs of the buildings and costs associated with such changes. Furthermore, the institute encourages Congress to pass legislation that would provide tax incentives to encourage energy-efficient building improvements.

— by Vijay Yadlapati, CCIM Institute's legislative liaison. Contact him at (312) 329-6033 or vyadlapati@ccim.com.

However, be clear: These measures may not have the desired level of impact hoped for, but doing nothing would have been catastrophic and thrown the credit markets into the abyss. Capital still is not moving in many markets. Where financing is available, there are many documented situations where, at the last minute, buyers have called off deals due to fear that they may be paying more than the property will be worth in six months. For now, investors are putting the majority of their investment dollars into cash holdings. Still, privately held commercial real estate is the

second-most-favored investment alternative, mostly because while real estate may have lost value, the losses are nowhere near what has been incurred in the stock market. Given the incredible losses and continued volatility it is no wonder institutional survey respondents showed the most aversion toward stocks.

As a leading indicator, the stock market bears watching, and we can expect that uncertainty will drive the U.S. economy until we see some stability in the stock market. Further, the length and depth of the economic recession depends, in great

part, on the restoration of confidence in U.S. markets, government, and business, which will, in turn, determine how commercial real estate will fare in 2009 and beyond. While we all hope for a relatively short down cycle, only time will tell what we will face with respect to commercial real estate. Finally, despite gloomy investment conditions and return performance projections, it is important to remember that all commercial real estate is used locally. What may be the trend on a national level may not be as strong an indication of what to expect in individual markets. ■

2009 Economic Outlook: Two Scenarios

This summary of economic drivers and commercial real estate performance characteristics compares the effects of a mild recession to that of a deep recession.

	RECESSION TO MILD RECOVERY— MOST LIKELY SCENARIO (70%)	DEEP RECESSION TO ANEMIC GROWTH — LESS LIKELY SCENARIO (30%)
Commercial real estate	Job loss slows, but businesses do not take on additional space. As a result, vacancy rates for all property types increase by half a percentage point by mid-2009, cap rates increase approximately 50 basis points before leveling off, and transaction activity eventually begins to increase, thus stabilizing pressure on rental rates and pricing. As the economy comes out of recession, the apartment sector is the first sector to see occupancy increase, followed by the industrial, hotel, and retail sectors, and finally the office sector returns when employment increases.	Unemployment increases steadily, and vacancy and cap rates increase for all property types. Sales activity remains sluggish, and prices continue to decline, putting further downward pressure on rental rates for all property types.
Characteristics	Credit is restored to the market and housing stability returns in early to mid-2009. Weak consumer spending leads to a 4Q08 recession, which ends by mid-2009 led by pent-up consumer spending.	The capital infusion to the credit market fails to prompt business growth and consumer spending. Continued fear about the economy and increasing unemployment slow investment and business growth.
2009 U.S. GDP growth	1% to 2%	-2% to 0%
Stock market	Investor confidence returns as volatility declines. Although down from record highs, the stock market stabilizes and better reflects corporate profits and losses.	Volatility continues and averages continue to decline. Investors have no confidence and stay away from the stock market.
Existing home sales	Home prices stabilize by mid-2009 and start to increase in the hard-hit areas.	Home sales, prices, and values stay flat or decline further (below historical normalized averages) in 2009, and foreclosures continue.
Unemployment	Employment stabilizes in 2009, with unemployment staying below 7.5 percent.	Multiple industries weaken further, with unemployment increasing to 10 percent in 2009.
Consumer confidence	Holiday sales are not as dire as projected, and consumer confidence and pent-up demand increase in early 2009.	Consumer confidence remains low for an extended period, with consumer demand remaining flat through 2009.