

# U.S. Quarterly

## Market Perspective

### Executive Summary

- The U.S. economy appears to be awakening from its doldrums, with numerous indicators pointing toward positive growth going forward. However, commercial real estate market fundamentals are likely to be weak through at least 2010, or until jobs grow at a healthy pace.
- There are signs that the worst of the credit crisis is behind us. The CMBS market remains largely out of commission, but large banks are taking small steps toward new lending, the appetite of life companies is increasing and some new specialty lenders are forming.
- Transaction activity remains low, as few property owners want to sell when prices are depressed and banks are reluctant to foreclose. Property sales through September are down 75% from 2008 and more than 90% from 2007 volume. (Source: Real Capital Analytics)
- Property values tumbled 4.9% in 3Q09, as measured by the NCREIF Property Index. The index's appreciation returns have fallen 28.3% since peaking in 1Q08, and will probably fall another 10% from their peak before the cycle ends.
- REITs extended the strong rally that began in March, posting their best quarterly results in the 27-year history of the NAREIT Equity REIT Index. The bounce was due partly to the sector having overshot on the downside in the prior year, and partly to their continued success in raising capital.

### Overview

The commercial real estate market presents a bit of a paradox. Property values continue to fall, the outlook for fundamentals is weak, and the debt markets remain relatively dysfunctional. Nonetheless, a tone of optimism has crept into the market despite these bleak conditions. Some of this may reflect the broad sense of relief that the worst of the financial crisis has passed, the improved economic conditions, and the rally in the equity markets. Or it may reflect the sense that a floor is forming for property values and that distress-induced transactions – which have yet to materialize – will soon become more widely available. Distress that has been evident to date has mostly involved non-income producing assets, such as land and failed condo projects, which represent a disproportionate share of the real estate holdings of some troubled regional banks.

There appears to be a meaningful amount of capital prepared to step into the market, either private equity that was raised and not spent before the onset of the crisis or, more recently, record levels of debt and equity issued by REITs. But the scarcity of distressed sales of stable, income-producing properties in major markets leaves many market participants waiting and watching for the “buying opportunities of a lifetime.”

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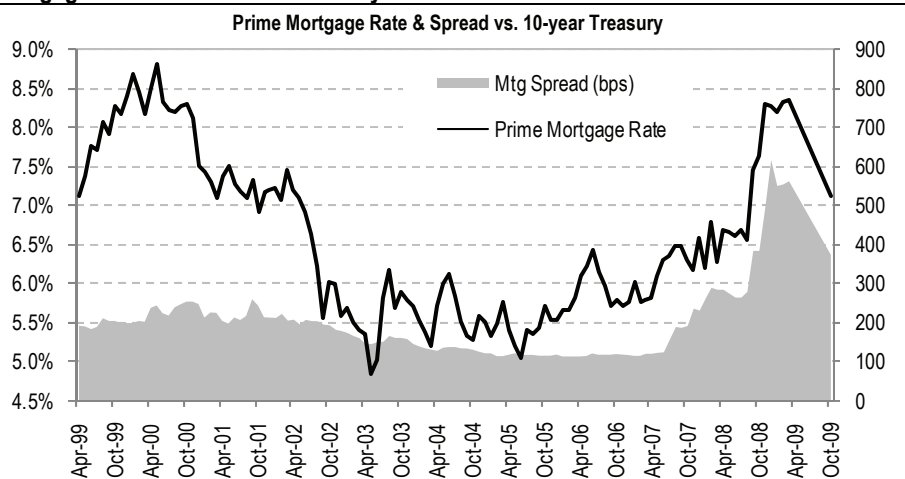
## Debt Markets

Mortgages are no longer a toxic topic at many institutions. That doesn't mean mortgage capital is flowing freely, but the total freeze on originations is giving way to a trickle of activity. CMBS remains dead, save for the mortgage agencies, and commercial banks are originating at a fraction of their former pace, but life companies are stepping up and a slew of new specialty lenders are trying to get into the mix.

Commercial banks, which represent about half of the \$3.5 trillion commercial-mortgage market, remain largely stuck in the "extend-and-pretend" mode. Some banks are originating loans for balance sheets, but the capacity and appetite for such deals is limited. Many banks are working through issues emanating from distressed loans that they wrote or inherited through mergers and thus most of their mortgage business encompasses extending existing loans. More than half of commercial mortgages by volume are held by the largest 100 banks, but those assets represent just more than 15% of their loan books, according to the FDIC. Now a full year after Lehman Brothers filed for bankruptcy, the largest of these banks are undercapitalized, but are no longer preoccupied with remaining solvent.

On the other end of the spectrum are regional banks with between \$100 million and \$10 billion of assets. These banks own a smaller portion of total commercial mortgages outstanding, but those holdings represent about 45% of their loan books on average, according to the FDIC. The commercial bank delinquency rate climbed to 7.9% at the end of the second quarter, up from 6.4% as of March 31 and 1.4% in 1Q07, according to the Federal Reserve. And most likely, the rate has not yet peaked. Because regional banks fund a large portion of local developments, an asset class likely to be hit hard by the recession and lack of demand for space, many are likely headed for failure.

### Mortgage Rates Have Eased Recently



Prudential Mortgage Capital Company, Federal Reserve, PREI Research

The biggest improvement in lending activity has come from the life company sector. A few months ago, just about all insurers were out of the market or had cut back activity drastically, largely because they were worried about rising delinquencies in existing portfolios and increasing exposure to an out-of-favor asset class. But those fears have given way to the realization that commercial mortgages offer good relative value, especially when compared to the yields of government bonds or other alternative investments. For

example, Baa corporate bond yields dropped to 6.1% at Sept. 30 from 8.6% in March, according to Moody's. Reflecting the increasing competitiveness in the market, life company spreads have contracted approximately 200 bps in the last three months, but at 300-350 bps remain wide by historic standards. With the prevailing conservative underwriting standards, 50-60% LTV loans provide attractive yields on a risk-return basis.

Another emerging source of debt, albeit small, has been public and private specialty lending firms. For example, newly formed mortgage REIT Starwood Property Trust, led by the former co-head of Goldman Sachs' CMBS operation, raised nearly \$1 billion in an initial public offering (IPO) in August. However, other mortgage REIT start-ups have since had to reduce the size of planned offerings or postpone IPOs indefinitely, raising questions about the scale of capital that can be raised in this sector. While the spate of new specialty lenders will help at the margin, particularly in financing riskier assets, to date they represent a limited amount of capital.

Troublesome for the market is that the increased activity of life companies and the emergence of specialty firms falls far short of filling the void left by the decimated CMBS market. At their peak life insurers wrote slightly more than \$40 billion of commercial mortgages annually, compared to peak CMBS issuance of \$230 billion in 2007. According to the American Council of Life Insurers, in the second quarter life companies made \$4.6 billion of mortgage commitments, up 77% from 1Q09; a vast improvement but a drop in the bucket relative to the amount needed to replace the roughly \$400 billion of debt that is scheduled to mature in 2010.

Despite the efforts of the government's Term Asset-Backed Securities Loan Facilities (TALF) program, the CMBS market does not appear to be reviving anytime soon. TALF provides cheap financing to buyers of triple-A-rated CMBS, which in theory will bring down spreads and make it cost-efficient to write new loans. CMBS spreads did rally after the program was established, but not enough to spur much new lending. One complication came from the rally in REIT corporate bonds. A handful of REITs were considering raising debt via TALF-generated CMBS transactions this summer, but most decided to issue unsecured corporate bonds because it was less expensive and provided more certainty of execution. While CMBS spreads have dropped to the point where it is possible for securitization programs to write loans at a coupon that a borrower might accept, and some banks are starting to originate a few loans with securitization in mind, multi-borrower CMBS deals of any size are unlikely anytime soon. Banks remain reluctant to warehouse loans when CMBS prices remain volatile and hedging instruments are unavailable.

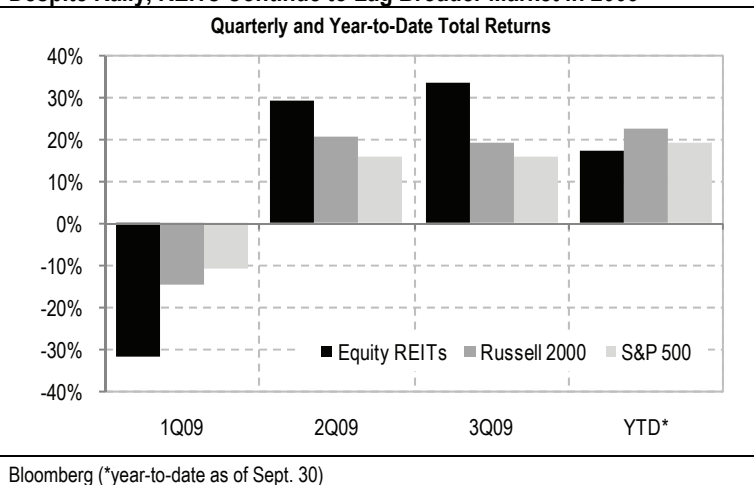
The one area of the commercial mortgage market that is stable is multi-family lending, as the government mortgage agencies provide higher leverage and lower coupons than is available for any other asset class. Freddie Mac has funded nearly \$2 billion of multi-family loans via securitization so far this year.

Overall lending volume is down due to the dearth of transactions and lack of demand for refinancings. From a borrower's perspective, today's debt terms are not terribly attractive. Pricing and availability have improved, but proceeds remain far below levels that borrowers had grown accustomed to in recent years. Many prefer to extend existing loans with the expectation of locking in a long-term deal when conditions are more favorable for borrowers. As long as cash flows are sufficient to service debt, many borrowers and banks will likely choose to hold on until market conditions improve and there is greater clarity on asset values.

## REIT Market

After pausing briefly in June, U.S. equity REITs extended their dramatic back-from-the-abyss rally that began in March. From its March 6 closing low through the end of the September, the FTSE NAREIT Equity REIT Index (price only) soared nearly 96%, far outpacing the S&P 500 index, which also surged, gaining more than 56% from its March low. By the end of the third quarter, the total return year-to-date for the equity REIT index stood at about 17%. While the rebound obviously was a welcome change from the dreadful performance at the start of the year, equity REIT performance in 2009 continued to lag large and small cap stocks, as measured by the S&P 500 and Russell 2000 indexes, which delivered total returns of 19.3% and 22.4%, respectively.

### Despite Rally, REITs Continue to Lag Broader Market in 2009



The initial catalyst for the rally was the growing recognition on the part of investors that the financial system was not going to collapse. After government authorities and central banks around the world pledged to take whatever actions necessary to support the global banking system and financial markets, capital flows out of risk assets slowed, and investors gradually began to inch back out on the risk curve. For REITs, the real spark came when a handful of management teams took advantage of the subtle change in sentiment to raise some very expensive capital, which they used to begin delevering their balance sheets and to address near-term debt maturities. While the first companies to act paid dearly for the capital they raised, most were rewarded with expanding multiples as their share prices recovered from extremely depressed levels.

The remarkable rally in the corporate bond market during the summer provided an opportunity for REITs to raise new equity and debt. REITs raised \$10.7 billion in fresh capital in 3Q09, including \$4.3 billion of unsecured debt in August and September alone. The flurry of activity, which included a few mortgage REIT IPOs, pushed the year-to-date total capital raised to nearly \$30 billion. Most of the capital raised to date continues to be earmarked for delevering and refinancing existing debt. But the improved access to capital has allayed investors' concerns about solvency and made shorting the sector a much riskier proposition.

By most metrics, REIT valuations now appear stretched. The rally in share prices has pushed REIT dividend yields down sharply. At the end of 3Q09, the average dividend yield (cash-only) for the NAREIT

Equity REIT Index was about 4%, roughly 500 bps lower than at the end of the first quarter. But with benchmark interest rates at extremely low levels and the rally in corporate bond spreads, REIT dividend yields are not unattractive, especially when the dividends that are being paid in shares are considered. When adjusted for dividends paid in shares, the effective yield at the end of 3Q09 was about 140 bps higher. Still, REIT earnings are trending down and will likely continue to fall throughout 2010, while earnings for the broader stock market are expected to bounce back strongly.

Where REITs go from here is a tricky question. Capital flows into dedicated REIT mutual funds and ETFs have been positive for most of the year, including 10 out of 13 weeks in 3Q09, and anecdotal evidence suggests that more non-dedicated investors are looking at the sector again. REIT share prices likely have discounted further deterioration in property market fundamentals and REIT earnings over the next 12 months. Whether they have over- or under-estimated the magnitude of the decline in earnings will depend on the timing and strength of the job market recovery. But since the recovery is not likely to be evenly distributed across all markets and regions, performance of individual companies will continue to vary widely. With investors focusing increasingly on fundamentals, companies that fail to meet expectations may be susceptible to selloffs. Although volatility has eased significantly from earlier this year, it remains high enough that the market could see a meaningful pullback – or pop – on any given day. Over the next 12 months, we expect equity REITs should deliver total returns of 6% to 8%, on average. If the broader equity market pulls back, however, REITs will not be spared.

## Property Markets

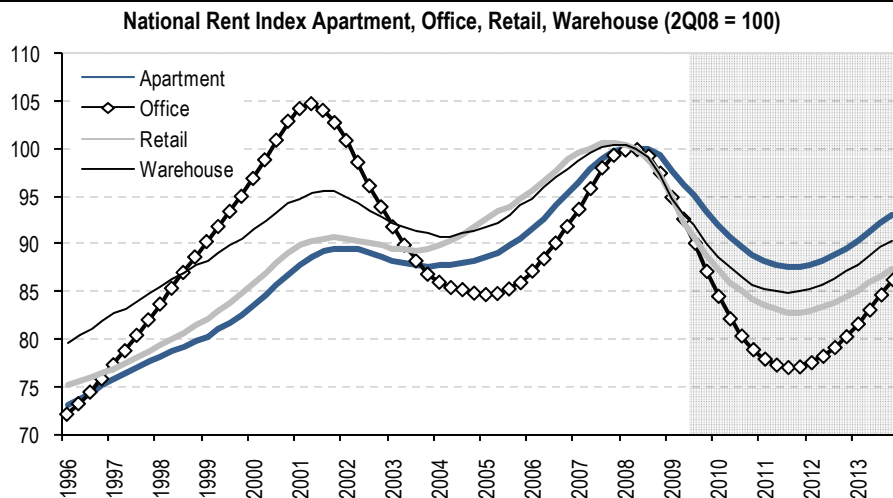
There is a growing sense that the worst of the economic crisis is over. The U.S. economy is expected to grow at a 3% annual rate in the third quarter, which wouldn't be notable except for the fact that it should be the first quarter of GDP growth after four quarters of contraction. The S&P/Case-Shiller home price index, although dismal by historical standards, has moved in a positive direction for several months, possibly indicating that home prices have bottomed. Consumer spending also appears to have stabilized, albeit at a lower level than in early 2008. Retail sales, excluding autos and gas, increased by 0.6% in August over July, and rose another 0.4% in September.

However, the economy lost 263,000 jobs in September, bringing the total to 7.2 million since December 2007. Real estate fundamentals cannot improve until job numbers turn positive, which is not expected to happen until the middle of next year. Without steady job growth, demand for commercial real estate will remain weak and property owners will be unable to maintain and/or increase cash flow. What's more, experience from past recessions indicates that it could be several quarters of job growth before we see improvements in metrics such as vacancy rates, rent growth and net operating incomes.

*Office:* With the unemployment rate closing in on 10%, office vacancies climbed to 16.5% as of Sept. 30, according to Reis. The data firm said that negative net absorption since 1Q08 has totaled 106.5 million square feet nationally, enough to reverse the positive absorption of the prior two years, when rents peaked. Rents have slipped 7% since mid-2008 and may drop 23% from that peak before the cycle is over, according to Property and Portfolio Research (PPR). It could be years before income returns to 2007 levels. Because it is difficult to bring in new tenants, landlords are focusing on keeping existing tenants from moving, which means they are lowering asking rents and offering incentives such as free-rent periods. If a tenant is lured to another location, the prospect of finding a replacement is dim. Anecdotally, sentiment

among tenants appears to be changing at the margin, perhaps in response to the improving outlook for the economy and a growing sense that the balance of power in the leasing market is as favorable as it will get.

**Property Fundamentals Likely to Get Worse Before They Get Better**



Property and Portfolio Research, PREI Research

*Retail:* There are signs that consumer spending has stabilized, but it remains 8-10% lower than the peak levels that drove the economic machine before the bubble burst. Given the wealth destruction from falling home prices and shrinking investment portfolios, mounting job losses, increased personal savings and less credit available, the sales numbers are unlikely to grow much in the near term. Nationally, vacancy rates of retail properties have risen nearly 200 bps in the past year – to 8.6% for regional malls and 10.3% for community centers, while effective rents have fallen to 2006 levels, according to Reis. On the positive side, very little new product is being built, but rents will drop until empty space is absorbed.

*Apartments:* The multi-family sector also is struggling, as poor employment conditions have prompted apartment dwellers to double up or live with parents, while the glut of unsold single-family houses and condominiums provides competition. The national apartment vacancy rate of 7.8% is the highest it has been since 1986, and most markets will hit record high vacancy rates in the cycle, according to Reis. Recovery could happen more quickly in apartments than other sectors, though, as new supply is almost nonexistent and demand may improve quickly when job creation turns positive.

*Warehouse:* A sector that generates demand through economic growth and retail activity is bound to be impacted by a severe recession. Speculative new supply has fallen quickly as financing and demand for space have vanished, but the damage from excess development in 2007-08 has been done. According to PPR, between 1Q07 and 1Q10, supply of warehouse space will reach about 350 million sf while net absorption will total less than 3 million sf. The overall vacancy rate in the 54 markets that PPR covers is expected to increase to 13.7% by year-end 2009, up from 8.7% at year-end 2007. Rising vacancies will continue to weigh on rents, which are expected to decline throughout 2010.

*Hotels:* The numbers grow ever worse for hotels. Year-to-date through September, average occupancies of U.S. hotels dropped to 56.6%, down 10.3% from 62.8% in 2008, and revenue per room (RevPAR) fell to \$55.48, down 18.1% from \$67.72 in the year-ago period, according to Smith Travel Research. The worst hit

sectors were luxury (down 26.8% in RevPAR year-to-date) and upper upscale (-19.8% in RevPAR year-to-date). With families traveling less and corporations continuing to tighten belts on travel budgets, near-term prospects for improvement are slim. That could lead to a wave of delinquencies and distressed transactions in hotels, which have more than \$40 billion of syndicated bank debt and CMBS scheduled to mature over the next few years.

The third quarter saw \$10.8 billion of property transactions in the U.S., more than any other quarter this year, but still pale in comparison to healthy market numbers, according to Real Capital Analytics (RCA). Anecdotal evidence indicates that there is no shortage of investors willing to buy properties, although there remains a gap between the prices that sellers will accept and investors will pay. An increase in distressed transactions is anticipated, given the rising number of delinquencies. According to RCA, \$7.6 billion of properties joined the ranks of distressed in August, bringing the total of distressed assets to \$137.8 billion. Lenders are reportedly in the process of taking back some large portfolios that were purchased at the market peak with high debt loads. Examples include Morgan Stanley's purchase of Houston REIT Crescent Real Estate Equities and a Tishman Speyer partnership's purchase of the Peter Cooper Village and Stuyvesant Town apartment complexes in Manhattan. Few distressed situations have been resolved, but an increase in transactions seems inevitable, given the numbers.

Despite the percolating changes in market conditions, our forecast for returns for the NCREIF Property Index in 2009 is unchanged. We expect a peak-to-trough change in NPI's appreciation returns of about -40% for the cycle and a drop of between 25% and 30% in 2009. With income returns of about 7%, total returns will total -18% to -23% for the year.

### **Closing Thoughts**

Even as the general economy appears to be recovering, real estate fundamentals will lag behind, being dependent to a large degree on job growth and the strength of the banking sector. Yet investors who retreated from the sector just a few months ago are returning, and property owners who are under no pressure to sell seem more inclined to hold assets today in hopes that the capital and space markets will improve. The massive deleveraging is just in its beginning phase, likely to extend for years. A large number of commercial mortgages originated between 2005 and 2008 are likely to default, either because the properties are underperforming or borrowers will not be able to refinance with the same level of proceeds.

It remains to be seen whether we will see a wave of distressed transactions such as the early 1990s. Buyers are having a very hard time finding assets at the pricing levels that property owners themselves often acknowledge might be appropriate if they were forced to sell. That few property owners are choosing to sell in the current environment does not mean that asset values have not been marked down significantly from the peak. It merely suggests that property owners who are not under any pressure to sell would prefer to buy their own assets at today's valuations. Should this persist, the distress is less likely to be manifested in a big sell-off. It is possible that there could be a slow-motion wave of recapitalizations over a number of years that will involve lenders, property owners and investors who come to the table with capital.

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