

# Emerging Trends in Real Estate®

# 2010

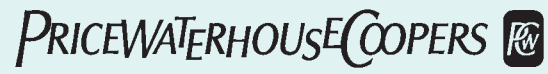


PRICEWATERHOUSECOOPERS 

 **Urban Land  
Institute**

## Emerging Trends in Real Estate® 2010

A joint venture of:



# Emerging Trends in Real Estate®

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# Executive Summary

After more than a year spent in suspended animation lagging already shattered housing markets, the commercial real estate industry hits bottom in 2010, suffering a surge of painful writedowns, defaults, and work-outs. Massive government infusions finally build up loss reserves in financial institutions to levels allowing them to foreclose or strike deals with many overleveraged borrowers. In turn, banks will start to dispose of real estate owned, and government regulators will package and sell more bad loans and real estate assets acquired in takeovers of increasing numbers of failed community and regional banks. Transaction markets will begin to thaw and value declines ultimately will average more than 40 percent off mid-2007 pricing peaks. These property market reversals likely will be the worst registered since the Great Depression, eclipsing the industry debacle of the early 1990s.

In a classic timing play, investors with cash should be poised to take advantage of highly attractive buying opportunities at cyclical lows. Stressed owners, meanwhile, gird to hold on if possible and try to maximize property cash flows by focusing on asset management and leasing strategies in a decidedly tenants' market. *Emerging Trends* surveys indicate that 2010 will be the worst time for investors to sell properties in the report's 30-year history, but will offer a much-improving environment to buy (with cash).

Debt markets will remain severely compromised—resuscitated banks will increase lending slowly, employing strict underwriting standards and requiring significant equity stakes from borrowers. Moribund CMBS markets remain entangled in complex workouts of failed multitranch structures with mounting levels of troubled loans maturing through 2015. Restoring confidence in a revamped CMBS model becomes a major priority for the government and financial industry, but a quick fix is unlikely.

A lackluster economic recovery characterized by problematic job growth will hamper the pace of any real estate market resurgence, which probably cannot gain much traction until late 2011 or 2012. In the meantime, rents and occupancies will continue to fall well into 2010, savaging the prospects of weakened owners struggling with financing issues.

Retail and office properties take the biggest hits—debt-burdened consumers continue to rein in shopping and companies delay rehiring while looking to shave occupancy costs and improve productivity.

Once hiring increases, apartments should rebound more quickly than other sectors thanks to pent-up demand from the expanding population of young adults—20-somethings get tired of living with parents and doubling or even tripling up with roommates.

The pummeled hotel sector also can benefit quickly once businesses start to loosen travel budgets.

First-to-hit-bottom housing markets stabilize further, despite more foreclosures, and show modest improvement in some areas as home-

buyers look for generational deals. But restrained mortgage lenders and cash-poor purchasers limit the scope of any rebound.

Developers go on enforced holidays. Commercial property sectors generally avoided overbuilding, but slack demand pushes up vacancies and many new projects can't hope to meet leasing projections or debt-service obligations. Values sink well below replacement cost and any construction loans will be extremely expensive to negotiate. Development doesn't pencil out when investors can buy existing real estate in the bargain basement.

Metro market prospects decline from coast to coast, but investors expect the nation's premier 24-hour gateway cities to weather the ongoing turmoil better and recover more quickly than most interior locations and secondary cities. Value losses will be mitigated somewhat in the top-tier markets as institutional and foreign buyers look to acquire prime assets, keeping prices from free fall—cap rates in these cities rise close to or above historic norms from unsustainably low levels.

"Recession-proof" Washington, D.C., regains the survey's top position, but San Francisco, Boston, and New York maintain reasonably positive long-term outlooks despite carnage to key employers, especially in the financial industry. Other California markets, including Los Angeles and San Diego, lose some luster over concerns about government budget deficits, high costs, and increasing tax burdens. Texas metropolitan areas gain in relative standing—interviewees like their business-friendly environments and sustained population growth, and housing prices avoided sharp swings. Florida markets and Southwest desert citadels—Phoenix and Las Vegas—take it on the chin from housing meltdowns and condo/resort overbuilding. Sadly, ratings drop to new lows for many cities in the country's manufacturing belt—auto manufacturer woes amount to piling on.

Canada's "boring" real estate markets elude direct impacts of the U.S. credit market collapse, but can't escape fallout from lowered demand and global recession. Conservative banking practices and stricter regulation kept lending in better check and most investors were saved from overleveraging. Only hot-growth Calgary looks overbuilt—other major cities suffer rising vacancies and flattening rents, but sidestep significant distress. Total value losses will be manageable—10 to 20 percent off highs. Markets should enter a slow recovery phase by year-end 2010, but interviewees see better investment opportunities eventually in top U.S. and European cities, which could rebound more sharply after steeper declines. In the meantime, Canadians worry about suffering more economic shocks, if their primary trading partner south of the border can't get its financial house in order more quickly.

Latin American investment opportunities center on Brazil, a rising global economic power. Mexico's fortunes decline in lockstep with its U.S.-centric economy.

## Preface

*Emerging Trends in Real Estate*® is a trends and forecast publication now in its 31st edition, and is the most highly regarded and widely read forecast report in the real estate industry. *Emerging Trends in Real Estate*®, undertaken jointly by the Urban Land Institute and PricewaterhouseCoopers, provides an outlook on U.S., Canadian, and Latin American investment and development trends, real estate finance and capital markets, property sectors, metropolitan areas, and other real estate issues.

*Emerging Trends in Real Estate*® 2010 reflects the views of more than 900 individuals who completed surveys or were interviewed as a part of the research process for this report. Interviewees and survey participants represent a wide range of industry experts—investors, developers, property companies, lenders, brokers, and consultants. ULI and PricewaterhouseCoopers researchers personally interviewed over 275 individuals and survey responses were received from 710 individuals whose company affiliations are broken down as follows:

Private Property Company or Developer	55.8%
Institutional/Equity Investor or Investment Manager	13.0%
Real Estate Service Firm	9.1%
Homebuilder or Residential Land Developer	7.2%
Bank, Lender, or Securitized Lender	6.90%
Publicly Listed Property Company or REIT	4.6%
Other	3.3%

A list of the interview participants in this year's study appears at the end of this report. To all who helped, the Urban Land Institute and PricewaterhouseCoopers extend sincere thanks for sharing valuable time and expertise. Without the involvement of these many individuals, this report would not have been possible.



# Timing Play

“Coping with pain.”

More investors recognize massive losses—value declines will eventually total “40 to 50 percent” off market highs, propelled by lagging impacts of the deep recession. Concussed lenders increase writedowns in riddled portfolios, and many overleveraged owners finally get wiped out, either in foreclosures or by turning back keys to banks. The inevitable borrower capitulation follows in the wake of high unemployment and faltering demand for space—property cash flows won’t improve fast enough to offer rescues from negative leverage purgatory. Constricted credit channels—hobbled lenders and a comatose CMBS market—leave more responsible and equity-rich investors without reliable refinancing options. Government loan supports and guarantees probably will be necessary to avoid greater carnage—even some of the most sophisticated and highly respected property players need lifelines.

Not surprisingly, the overwhelming sentiment of *Emerging Trends* interviewees remains decidedly negative, colored by impending doom and distress over prospects for an extended period of anemic demand and costly deleveraging. As we said last year: “There’s no quick fix.” Vacancies will continue to increase and rents will keep on decreasing across all property sectors before markets hit bottom sometime during 2010. Once a property market recovery begins and gains traction, probably before 2012, any rebound will be restrained by a lackluster economy and rising interest rates.

Despite this enveloping gloom and the dramatic fallout from the unprecedented early-2000s credit binge, 2010 and 2011 could be “the opportunity of a lifetime,” a limited window to cash in on one of the best acquisition environments ever. “The overall negativity paves the way for winners playing against

overall sentiment.” A sense of nervous euphoria grows among liquid investors who can make all-cash purchases. If “patient,” “daring,” and “selective,” they could score generational bargains on premium properties, once owners “cry uncle” and banks start to clear the decks of their rapidly expanding and unwanted bad loan and real estate-owned (REO) portfolios. Among real estate investors, the worst of times ultimately generate the biggest gains for savvy investors in what has become an increasingly cyclical, market-timing business. “Whoever’s left standing will be in a great position.”

In the midst of severe market impairment and dislocation, the prospects for outsized buy-low rewards highlight the importance of effectively playing the real estate market cycle and subordinating asset allocation models and risk-adjusted return strategies. Sandwiched between mammoth value busts—the early-1990s industry depression and today’s “even worse” debacle—an unprecedented boom in real estate values produced huge gains for investors who cashed out early enough and used leverage wisely. But later entrants were savaged, especially when they overborrowed. “Those who play the cycle wrong lose every time,” says a leading researcher. “Asset allocation analysis is great for looking at history, but can’t stand up to the cycle.”

Real estate’s touted attributes—low volatility and steady income—require “reevaluation,” says a top investment manager. “Over the past nearly 20 years, real estate has been highly volatile and the next several years will likely show compromised income flows. We sold the stability and the income, then got caught up in growth and opportunistic gains. Now all bets are off in the losses.”

Leverage and easy credit arguably distorted real estate's risk/return profile. The flood of Wall Street capital, particularly from public debt markets, helped transform real estate into a commodity. "It became a trading game," dominated by momentum investors who transacted among themselves and bid up prices. If managed conservatively, real estate can retain its bond-plus risk/return elements, but that means buy, hold, and keep leverage manageable, and even then conservative core investors have suffered extensive losses, dragged down by the overall market. "Let's face it," says a veteran analyst, "without leverage, the asset class doesn't provide much opportunity for big upside. The difference in returns for core, value-add, and opportunity type funds is largely determined by how much leverage you put on, not particular property acumen unless you get into development."

Even those investors poised to jump in at the approaching market bottom guard against inflating expectations. "Real estate doesn't do 20 percent [annualized returns] real well," says a chastened public pension fund executive, and credit gridlock removes any near-term chance to use much leverage. Playing this up-cycle profitably will depend on buying right and operations—managing and leasing effectively.

Prepare for a monumental timing play.

## Survival of the Fittest

In retrospect, the commercial real estate markets existed in a deeply unsettling suspended animation through 2009. For industry players, the year was all about "muddling through," waiting for a market bottom, putting off hard choices, and desperately praying for a sharp economic rebound. Banks and special servicers delayed dropping the hammer on flailing borrowers and recognizing their loan losses in order to shore up depleted reserves with the help of low-interest government funds and other federal bailout programs. Stricken borrowers grasped at "pretend and extend" offers from bankers, but only put off their day of reckoning. Deal markets froze and developers hibernated.

**Time Runs Out Now.** "Getting through 2010 will be the test for who can survive. "Inertia starts to give way, the catalyst is simply time." "Underwater" borrowers will start making hard decisions about walking away or selling at big losses—they

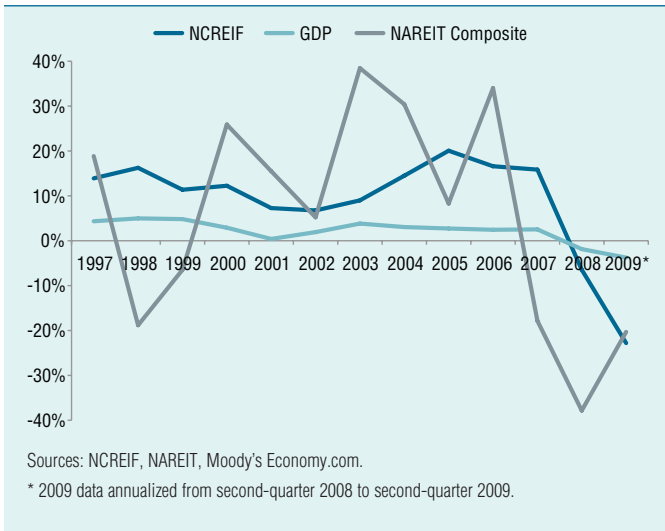
can't continue to incur capital costs while cash flows diminish from lowered rents. "Waiting is a bridge to nowhere since fundamentals won't come back fast enough." Banks will finally start to clear out bad loan portfolios and "take control of wasting assets to maximize proceeds." The Federal Deposit Insurance Corporation (FDIC) will step up disposition of loan portfolios from failed banks, using various government guarantees to entice buyers. A market bottom will form and sidelined equity capital will begin to reenter the markets, in some cases joint-venturing with banks to manage asset pools. In the meantime, values go down, fundamentals won't provide bumps in rents, and cap rates will stabilize or go up—"they're not coming down."

**Dum-Da-Dum-Dum.** Put another way—2010 looks like an unavoidable bloodbath for a multitude of "zombie" borrowers, investors, and lenders. Given the looming "train wreck" of escalating commercial mortgage-backed securities (CMBS) rollovers (\$250 billion to \$300 billion annually through 2015), the shakeout period may extend "several years" as even some conservative owners with well-underwritten loans from the early 2000s see their equity destroyed. "It's not just the unavailability of capital from damaged credit markets, it's also the decline in tenant demand—rising vacancies and declining rents."

**Another Bailout.** The refi bogeyman—"a doomsday without refinancing"—understandably sends chills through the industry. But well-placed banker interviewees expect the U.S. government "to put mechanisms in place" and help resuscitate securitization markets, "avoiding a fiasco." Their rationale is: after stanching big bank collapses and saving automakers, the government won't blow it all and let the economy tank from a total commercial real estate meltdown. Even with government intervention, the CMBS labyrinth traps borrowers and bondholders "in a limbo without good outcomes." Excessively complicated structures—multiple lenders, equity partners, mezzanine pieces, and securitized tranches—"could take years to resolve" in litigation nightmares and complex, not to mention costly, workout scenarios. And a government bailout inevitably entails short-term remedies that hamper longer-term economic soundness, potentially leading to larger federal deficits, more taxpayer stress, and rising interest rates.

Indeed, prospects for a tepid economic rebound now concern *Emerging Trends* interviewees as much as the ongoing credit market turmoil. "Real estate will be on the tail of any recovery, the longer the economy takes the tougher for us."

EXHIBIT 1-1  
U.S. Real Estate Returns and Economic Growth



## The Economy: “A Big Hurt”

By late 2009, the U.S. economy may have entered a “statistical” recovery, but lingering high unemployment and massive deleveraging hamstring growth outlooks. For starters, the nation’s consumer engine sputters under mountains of household debt—mortgage, credit card, car, and student loans—and the harsh reality depresses Americans at all income strata. Large and expensive lifestyles—McMansions, second homes, plush furnishings, SUVs, big-screen TVs, and shopping sprees—were mostly financed and now the sizable bills come due just as job security and confidence in future prosperity waver. Economic mainstays—financial services, homebuilding, and auto manufacturing—take direct headshots. With credit gone and people in savings mode, these jobs generators retrench, offering limited prospects for a quick resurgence. Lawyers, brokers, and other previously well-compensated transaction middlemen feel the bite, too.

**Everybody Borrowed Too Much.** Consumers are just part of the debt cataclysm. While the Federal Reserve kept interest rates low and set off the credit bomb, government spending largesse coupled with tax cuts ballooned government deficits. The severe recession forced leaders to double down on government spending and leaves taxpayers with a gaping hole to fill. Printing money for various industry lifelines sets

the stage for ramped-up inflation and higher interest rates—foreign T-bill buyers will want higher yields for taking on greater risk. And higher interest rates could deter business growth. “It all feels like a dead-cat bounce,” says an investment manager. “We’re past the panic stage thankfully, but the long-term impact of colossal government spending and national debt has yet to be felt.”

**“Not a Pretty Picture.”** Hovering over interviewees are big fears about a jobless recovery—“interest rates go up and the economy can’t pick up fast enough to produce jobs that fill buildings.” Recent experience on the employment front doesn’t bode well—“we’ve had fake growth.” The last two recessions effectively wiped out any income gains, the Internet and finance booms turned out to be bubbles, and Internet disintermediation shrinks media companies and starts to hit retail distribution. Manufacturing continues to migrate to cheaper offshore locations and now various service, financial analyst, and high-tech jobs can be poached by global competitors or transferred by U.S. companies operating overseas. Shockingly, America’s standard of living may have begun to fall—wages quiver, health benefits shrink, and companies slash pension plans. Can anybody depend on their 401K for retirement? Everyone in our survey struggles to identify new high-paying employment incubators that will spur recovery and tenant demand, finding consensus in a few sectors:

- **Technology:** Engineers and scientists will be highly coveted to develop novel computer software and green energy systems, and revamp dated infrastructure. New high-tech products can increase U.S. exports to burgeoning global markets.

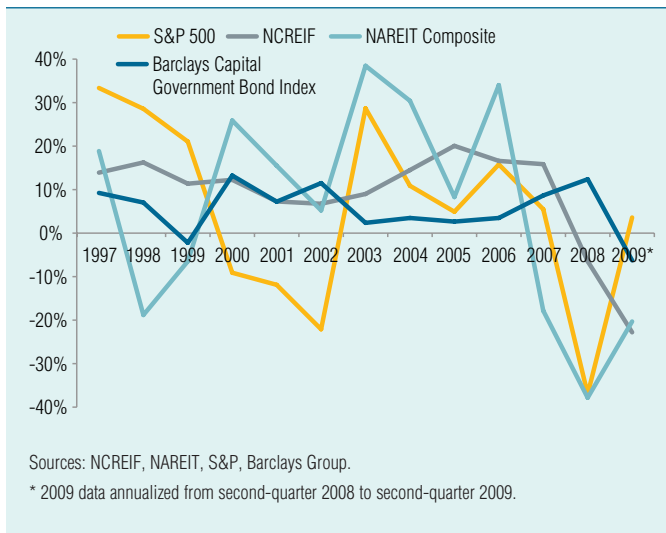
- **Health care:** An aging population will need more medical services from doctors, nurses, therapists, and caregivers. Biotech and drug companies benefit from increased demand for remedies and cures.

- **Education:** The country desperately needs more teachers to help educate engineers, scientists, and physicians for high-paying brainpower jobs that can lead to industry breakthroughs and innovation.

- **Housing:** Homebuilders will recover eventually—the U.S. population grows by 3 million annually and all these people need places to live.

- **Wealth management:** Everyone learns lessons about the need to save, but first we must pay off bills from all our borrowing.

EXHIBIT 1-2

**Index Returns: Real Estate vs. Stocks/Bonds**

The overall outlook doesn't suggest a wellspring of employment opportunity, particularly for many debt-strapped middle-class Americans, who had depended on well-paying blue-collar factory jobs. Some interviewees, meanwhile, grumble that "health care and teachers won't fill space on Park Avenue" and productivity gains by large U.S. multinational firms may boost their stock prices, but often come at the expense of domestic operations.

As the federal government tries to pick up the slack with stimulus, unprecedented deficits will constrain future spending unless taxpayers shell out more, a treacherous political prospect that cuts into consumer buying and business expansion. Alternatively, if the government really gets serious about cost cutting, many private sector jobs would be in the cross hairs. Federal contracts, including those for defense, could be curtailed and needed infrastructure improvements would be postponed. Budget-busted state and local governments confront reducing public employee workforces and benefits. Even the most optimistic, well-reasoned interviewees, who point to "overdone gloom," couch any enthusiasm and predict a "prolonged," "not very robust" U-shaped recovery.

## The Long Road Back

Under any circumstances, real estate players resignedly steel themselves for a "difficult," "much-slower-than-normal" come-back, tracking behind the problematic economy. "We're only in the early innings and 2009 has been a rain delay." Here's how interviewees see the obstacles and map out the "hard slog":

**Housing Leads.** The peak-to-trough drop for housing took a painful three years, finally reaching its nadir in 2009. Bargain hunters ignite an uptick in home sales, but an absence of easy credit, the household debt overhang, and weak economic turnaround limit buyer appetites. At least the tailspin stops.

**Huge Writedowns.** Banks need to recognize losses on commercial real estate and overleveraged borrowers must lose their shirts. "Only then will we reach market bottom." Bankers have been dealing with housing, next comes credit cards, and then upper-tier lending platform problems like commercial paper and commercial real estate. Unfortunately, "the problems get bigger with larger consequences."

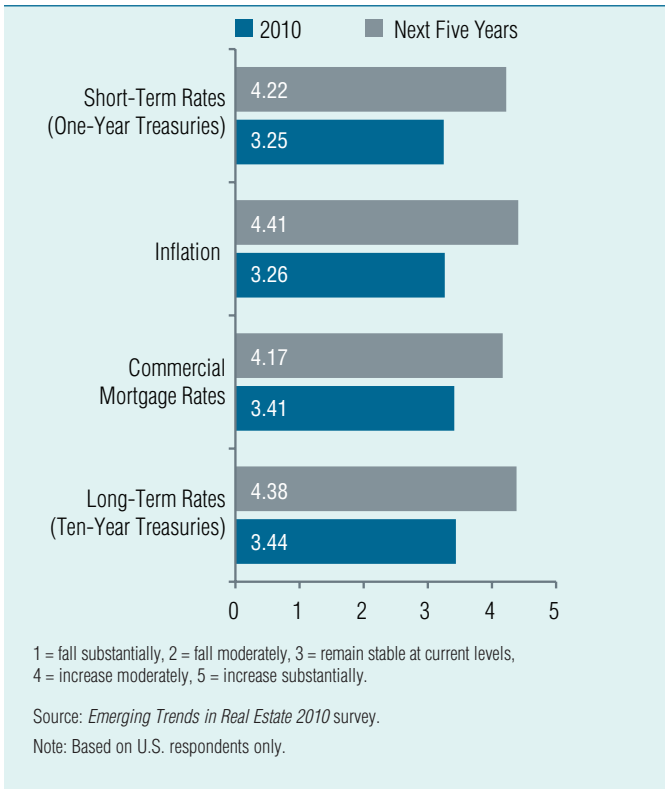
**Government Intervention.** In order to pave the way for rationalizing balance sheets, the feds will give more time for banks to build up loss reserves and provide some form of credit support for commercial properties, including TALF. "It's the only way out." Regulators must take steps to reform and resuscitate moribund CMBS, helping restore confidence in the bond markets. "Without capital from securitizations, real estate won't recover."

**Cash Buyers.** Liquid investors rule the real estate world in coming years, enjoying pricing power. Real estate investment trusts (REITs), equity funds, and high-net-worth individuals with dry powder will reenter at perceived market bottom, focusing on vulture deals for trophy properties in top markets, shoring up troubled borrowers who own prime assets in return for big equity stakes, and purchasing troubled loan portfolios at cents on the dollar. They try to sidestep the "dreck" in secondary and tertiary locations.

**IPOs.** Investment bankers pull out their early-1990s playbook to get back in the game. They structure public offerings to rescue failing equity funds and private real estate companies, and naturally they'll take big fees and a piece of the action along the way.

EXHIBIT 1-3

## Inflation and Interest Rate Changes

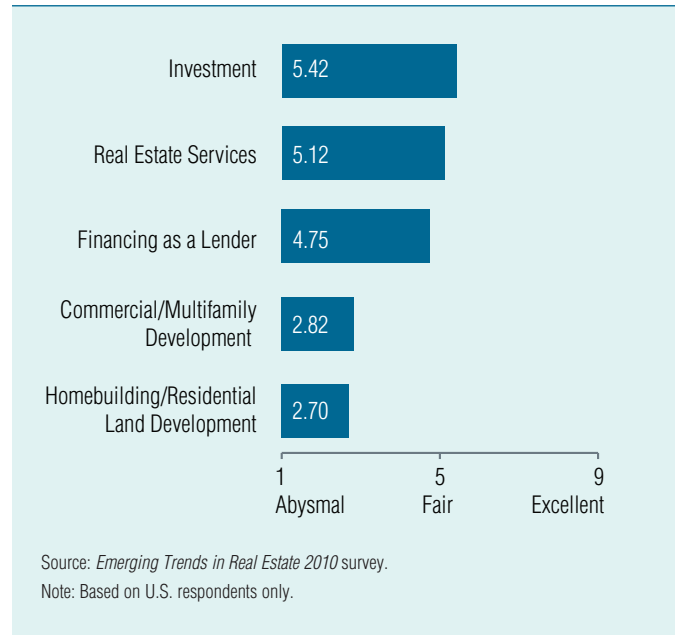


**Litigation Mess.** Workout specialists and lawyers enter a *Bleak House* of contention and confusion in trying to unwind “incomprehensible” CMBS and collateralized debt obligation (CDO) structures. Figuring out who owns what could take “an eternity” to resolve. In the end, lower-rated tranche positions may be worthless anyway.

**Rate Hurdles.** The specter of rising inflation and higher interest rates presents huge obstacles, and many interviewees predict that “rates have nowhere to go but up” to tamp down inflationary pressures from all the government borrowing. (See Exhibit 1-3.) On the other hand, “the only way out of our debt problems is inflation” since it increases the value of depreciated, highly leveraged assets and can rescue underwater borrowers. Inflation also makes hard assets like real estate more valuable. But inflation would be anathema to the Chinese, Japanese, and other T-bill buyers who might demand sharply higher interest rates to protect them from a depreciating dollar. If these governments and other investors balk at buying Treasuries, the United States could be forced into an austerity mode, some combination of high taxes and severe spending

EXHIBIT 1-4

## Real Estate Business Activity Prospects in 2010



cuts. And higher interest rates not only would put downward pressure on property values, but also could constrain business expansion and consumer spending, which would curtail job growth. In sum, “it’s a tough path,” whichever way the federal government implements monetary policy.

And it all means “any real estate recovery will be slow.”

**“Absolutely No Demand.”** Unlike 20 years ago, when massive overbuilding and a relatively mild recession combined to tip over commercial property markets, this time the absence of demand drivers has debilitated property owners who were counting on increasing cash flows to meet expensive debt service. Landlords, clenching mortgage statements, watch forlornly as tenants downsize and cut space costs to bolster their prospects coming out of the prolonged economic downturn:

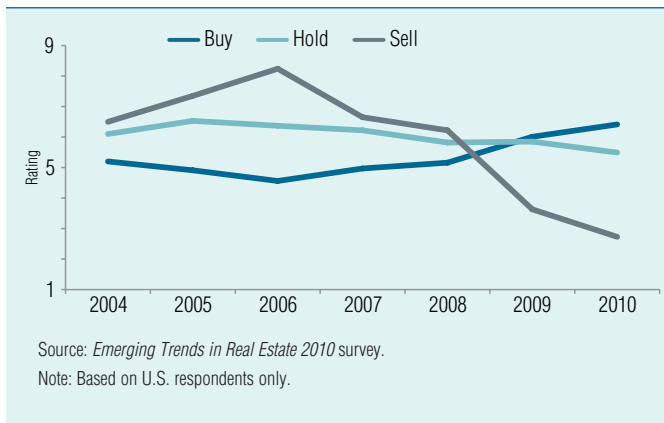
■ **Retailers** close weaker stores, concentrating on the strongest shopping centers.

■ **Apartment renters** double up or move back in with parents or siblings.

■ **Office tenants** look for productivity gains from lowering space-per-capita ratios and want big accommodations in rents and concessions.

■ **Warehouses** suffer record vacancies—the consumer pullback and retail contagion constrict the goods distribution pipeline.

EXHIBIT 1-5

**Emerging Trends Barometer 2010**

■ **Hotels** endure plunging “below break-even” occupancies—eliminating travel is low-hanging fruit both for businesses and families struggling to check spending.

“We’re in an extremely weak operating environment where tenants are unable to pay decent rents,” says an interviewee. “New construction is not our issue—we need new demand.”

Nobody holds their breath for 2010 in light of the less-than-robust economic outlook. “Employment growth always follows the economy, and real estate typically is the last to benefit from any improvement.” Once companies’ earnings increase from productivity gains and sales start to pick up, then businesses get more confidence to hire. This time, the ongoing credit crisis won’t help the process: bankers shore up reserves instead of helping businesses recapitalize, chilling expansion plans. “We’re in a box,” says a veteran investor.

**Development.** “Largely dead.” At least developers can avoid blame for the commercial market turmoil—“fortunately, nothing is overbuilt” (although let’s not forget condos). But that’s small consolation when recently completed projects careen immediately into defaults and opportunities for any new business may wait two or three years. “You can’t be a developer today,” says a longtime Texas builder. “The terminology just doesn’t apply in this market.” Given sharp value declines, the price of existing assets drops well below replacement cost, and the development pipeline dries up—“the smallest in history for all property types,” according to a leading researcher. Why build anything when you can

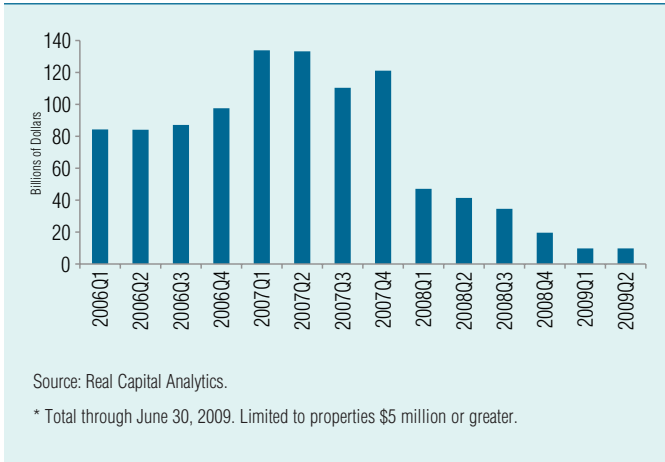
buy existing product much more cheaply? And in the highly unlikely event a developer finds a willing banker, any construction loans will come under stiff conditions and pricing, raising the stakes and risks. Longer term, inflation poses another challenge—ratcheting up construction costs for labor and material. “Right now, development is a joke!”

Facing “bleak” forecasts, a “Darwinian environment,” and capital constraints, more “bulletproof names” will get shot down. Some players, who agreed to recourse construction loans in the recent lending mania, “may lose everything.” Others “buy time” and “do what they can to survive,” becoming workout specialists or asset managers, or taking receivership to complete somebody else’s busted projects. If all else fails—“there’s fishing and golf.” Eventually, the construction shutdown leads to undersupply and helps speed recovery—any stepped-up demand can eat into vacancies more quickly. While they await the fallout, developers join a long line of other market victims.

**Vultures Circle.** Brokers and dealmakers also drop like flies in the unprecedented transaction freeze, but a thaw slowly materializes. Bid/ask gaps prepare to close—purchasers adopt traditional underwriting analysis using existing cash flows, while sellers “aren’t there yet.” And no wonder—the *Emerging Trends* transaction barometer signals the worst selling environment in report history. (See Exhibit 1-5.) Patient buyers can afford to hold out for some “fantastic opportunities.” They won’t rush to deal until they sense market bottom—maybe in late 2010, certainly by 2011, when motivated owners seek exits and banks finally start to clear their balance sheets. Wized interviewees counsel against “moving too fast.” Early deals may send prices lower—“some stuff will blow out at incredibly cheap prices.” And first-to-market properties often are “the worst of the worst—stuff you shouldn’t want.” But others point out that “no one rings the bell at the low point, so move if you find a good deal.”

In the meantime, anticipation steadily builds: “We’re headed back to 1980s prices” and “a buy one get one free” market environment. FDIC-sponsored deals may lead the way—“a tidal wave of properties” heads into receivership from community and regional bank failures. The government eventually will also undertake portfolio sales of billions of dollars in bad loans under its control. In these deals, buyers can expect “generationally low prices” with federal guarantees. For all the giddy talk, cash investors should temper return expectations, especially in top markets where enough bidders will keep “more realistic floors” on prices for Class A

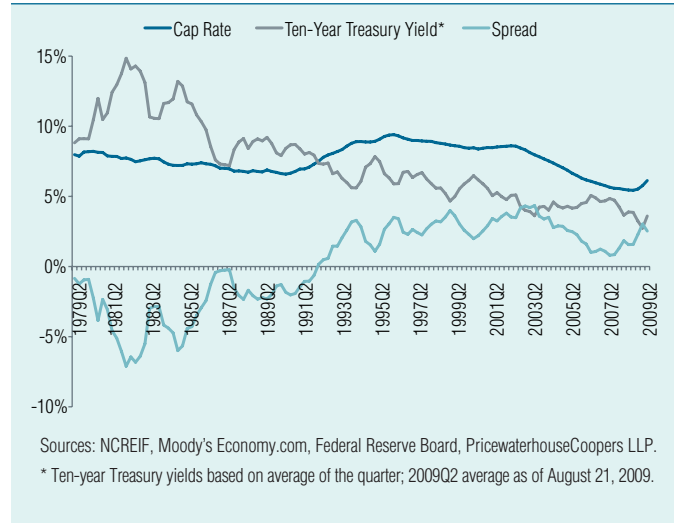
EXHIBIT 1-6

**Sales of Large Commercial Properties**

properties. Core yields will range in more traditional territory, the high single digits, while expected opportunistic yields for buying vacancy register in the mid to high teens. Forget 20 percent-plus unless you're still dreaming about 2006. The best deals may come under radar screens where compromised owners quietly restructure financing by taking preferred equity partners who garner attractive stakes in return for cash infusions. "I have plenty of new friends in the U.S. who want my capital," says an international pension executive. Many players just take comfort in the return of more normalized underwriting and analysis. "The old rules seem to be back; two years ago nothing made sense," says a portfolio manager. "Now I think I know what I'm doing again with my bearings back."

**Cap Rate Bifurcation.** Sadly, the 2000s turn into "a lost decade" for investors. Interviewees say they expect declines off peak 2007 values to total "40 to 50 percent," less for trophy assets, more for some B and C product. Extra dollops of leverage, which escalated returns in the rising market, now annihilate portfolios on the downside. After dropping into 5 percent-plus territory during 2006 and 2007, average cap rates for institutional-grade properties "will settle" in the 7.5 percent range, "a huge move" reflecting the depth of market declines. The consensus view shies away from underwriting "any growth in rents or decrease in cap rates for a long time." When interest rates increase, as expected, pushing up T-bill yields, cap rates could "go along for the ride." At the very least, "higher interest rates make it harder for cap rates

EXHIBIT 1-7

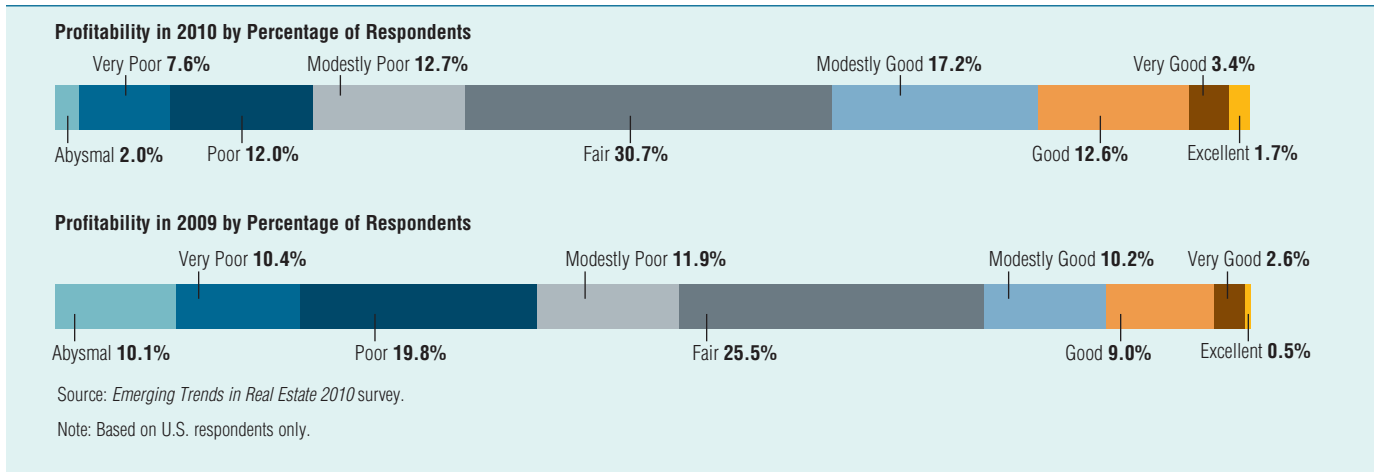
**NCREIF Cap Rates vs. U.S. Ten-Year Treasury Yields**

to recover" even when property cash flows improve. Expect "huge spreads" between "higher-income-stream and low-to-no-income-stream properties" as transaction markets gear up. "Cap rates actually look more normalized for top core properties, back to income with small appreciation based on first-year cash flows [in-place tenants]—but there are no cap rates for distressed properties." Given the absence of recent deals, some investors choose to ignore cap rate analysis entirely, concentrating instead on occupancies, rents, and year-to-year cash flow changes. "That tells you more."

**"We've All Laid Off at Least 20 Percent."** Many real estate firms go into survival mode, attempting to convert lifeless acquisition, origination, and development platforms into asset management, special servicing, and workout businesses. "They keep the best talent and downsize the rest." But the transformation can be challenging given the dearth of knowledge and experience among personnel for unwinding deals and crafting settlements. "Anybody in the business since 1994 only knows from transactions and never anticipated this mess. They just don't have the necessary skills, and law firms are simply understaffed without the expertise." Demand intensifies for real estate executives who know property operations or who have strong tenant and client relationships. "Starving" brokerage companies rely on property management and corpo-

EXHIBIT 1-8

**Firm Profitability Forecast**



rate consulting to shore up bottom lines. “We shrink along with shrinking values.” More conservatively run firms (they limited corporate debt and expensive expansions) “can take advantage of the chaos,” picking up business from failing competitors “who had been more aggressive.” Investment managers anticipate a shakeout—top performers with solid institutional backing and staying power take business from smaller “entrepreneurial” firms and underperformers. Pension plan sponsors start to consolidate separate accounts among their most favored advisers with strong asset management capabilities. Some limited partners in struggling opportunity funds cut deals to keep general partners in place when promotes evaporate, while other GPs are jettisoned or abandon their funds. “Compensation is a jump ball.” For now, competitor practices and HR salary studies don’t matter to CEOs and CFOs. “The only relevant metric is: did the firm make any money and how much can they afford to pay?”

Ever hopeful, *Emerging Trends* respondents peg 2009 as the low point for real estate firm profitability, expecting modest improvement for 2010. (See Exhibit 1-8.) Not surprisingly, they forecast better prospects for investment and service companies and poor to abysmal outlooks for developers. Overriding concerns about the economy, particularly job growth, and

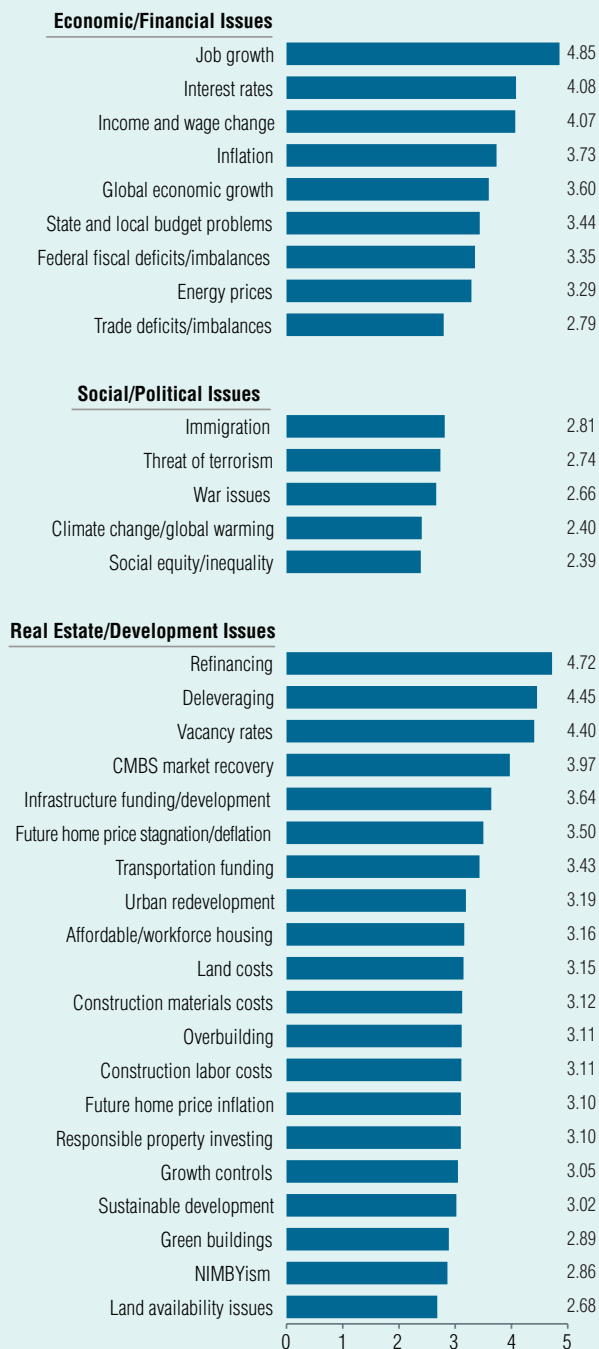
industry deleveraging crowd out much consideration of socio-political problems—climate change and green buildings get short shrift in this year’s survey. (See Exhibit 1-9.)

**Starting Over.** In the midst of dislocation, income destruction, and performance disasters, a paradoxical tension develops among real estate players. Interviewees talk about lessons learned and how survivors “will be more cautious and conservative.” Real estate, they say, is “a good business for B students who work hard, not for PhDs with computer models.” They perfunctorily reject the private equity paradigm based on leverage and promotes, which precipitated the downfall. But then in the next breath they say they want to make up the losses as quickly as possible. Nobody mentions investing in neighborhoods or place making for future generations anymore. Relationships among far-flung owners, lenders, tenants, and communities have disaggregated. “We used to talk about real estate as a local business,” says an industry graybeard. “But it’s not a local industry when borrowers don’t know their lenders, and owners don’t have a long-term stake in the places where they invest.” Despite the ongoing havoc from overdone wheeling and dealing, the investor mind-set skews back reflexively to trading and maximizing short-term profits. “When leverage comes back into the markets, you should take out your equity.” Flipping won’t return anytime soon, because of the economy, but the principal cements—commercial real estate is viewed by many as a highly fungible commodity. What happens after you sell it is somebody else’s problem.

For 2010, enormous problems will begin to morph into unique opportunities. It’s all about timing the cycle.

EXHIBIT 1-9

### Importance of Various Trends/Issues/Problems for Real Estate Investment and Development 2010



Source: *Emerging Trends in Real Estate 2010* survey.

1 = no importance, 2 = little importance, 3 = moderate importance, 4 = considerable importance, 5 = great importance.

## Best Bets 2010 Investment

**Deal with Cash.** Over the past three years, *Emerging Trends* has counseled to “keep powder dry” and wait for a correction. Now you know why. “Cash is the only way to operate” and “only the most liquid” can take advantage “of the ton of emerging opportunities.” Add leverage “for a bonus” once credit markets resuscitate.

**Don’t Rush.** “Early is the new wrong.” Although seller and borrower capitulation approaches at a bumpy market bottom, economic uncertainty will hamper any recovery and the absence of ready refinancing in lifeless debt markets adds more risk. In this murky environment, patience will be rewarded. Transaction trigger points include improving jobs numbers, visibility to asset pricing, and stepped-up tenant deals. “Ignore theory, require empirical evidence.”

**Focus on Quality and Be Selective.** Buyers can be less cautious about timing when acquiring premium assets in the best markets where deal cap rates revert to the mean (or above) and values drop well below replacement cost. “Buy it, manage it, wait for recovery, and expect to hold for at least a five- to seven-year period, allowing fundamentals to slowly improve.” Seek irreplaceable Class A properties with debt maturity problems in places like New York, San Francisco, and Washington, D.C. Recapitalize borrowers for joint venture stakes and preferred equity and make deals at discounts with lenders. “Anything Class A can come back”—that may not be the case with lesser properties.

**Stick to Global Gateways.** The dominant, 24-hour markets, which were the favored places heading into the collapse, will recover more quickly in the aftermath. Coastal cities and the handful of interior markets with primary international airports link to global commercial centers and concentrate the nation’s business activity. These gateways will continue to attract a preponderance of high-paying jobs.

**Buy Cash Flow and Real Yield.** Anticipate creating value by filling vacancy and increasing rents over time. “Use a cash flow–driven model, not a leverage-driven model.” “Without leverage you’ll make money, just probably not as much as in the past.”

**Buy Public REITs.** These stocks “come off the mat with a long way to go back up.” Reequitizations dilute existing shareholders, but raise dollars to solidify balance sheets and enable accretive market-bottom acquisitions. “Public companies now gain a tremendous edge—their weighted cost of capital is well below private investors” and their perceived staying power will help retain and attract more tenants to their properties, augmenting cash flows. Stockholders, meanwhile, reap relatively attractive dividends and have liquidity. Index buyers gain instant diversity across property markets.

**Provide Financing.** While recap and lend-to-own gambits should score for equity investors, lenders can make “the best senior loans in their careers at relatively wide spreads, using very conservative assumptions.” Focus on “boring” well-leased real estate—infill shopping centers, B apartments, and well-located office—owned by capital-constrained borrowers. “Three- to five-year loans can deliver low-teen returns.”

**Consider Distressed Debt.** Eventually, the government will dispose of large loan pools from failed banks, providing guarantees or supports to lure investors. The collateral may be dregs and difficult to assess, but these should be classic cents-on-the-dollar transactions. Lenders will start to sell, too. Distressed CMBS packages will be extremely hard to value—legacy borrower and bondholder complications will make analysis “like unwinding balls of yarn.” Excitement wanes over the expected transaction complexity.

**Implement Asset Management.** Assess what’s worth protecting in portfolios and shed failing properties with insurmountable leverage problems—stop feeding losers. Focus capital and resources on retaining and attracting tenants in properties with better long-term value, and safeguard net operating incomes against tenant pirating by competitors.

## Development

### **Write Off the Year, as Well as 2011 and Probably 2012.**

You can close up shop, hit the links, convert operations to asset and property management, or become a workout specialist like everyone else. Forget about construction financing—that’s a pipe dream. Some bigger players take over half-completed condos and stillborn office projects in receivership from defaulting competitors. A few build-to-suit opportunities present themselves. At least, prospects for homebuilders can only improve, but that’s not saying much.



**Dream about the Future.** Next-generation projects will orient to infill, urbanizing suburbs, and transit-oriented development. Smaller housing units—close to mass transit, work, and 24-hour amenities—gain favor over large houses on big lots at the suburban edge. People will continue to seek greater convenience and want to reduce energy expenses. Shorter commutes and smaller heating bills make up for higher infill real estate costs. “You’ll be stupid not to build green.” Operating efficiencies and competitive advantage will be more than worth “the minimal extra cost.”

## Property Sectors

**Buy or Hold Multifamily.** “It’s the only place with a hint of hope, because of demographic demand.” Scarce construction sets the stage for a strong rebound in any economic turnaround. “There could be a shortage of apartments by 2012.” Pounce on cratered development deals and pick off

stressed assets at “rock-bottom pricing,” including busted Class A condos and infill B apartments. Locations near transit corridors are prime.

**Buy Hotels.** Totally slammed, the hospitality sector “has the most potential to recover sooner,” especially higher-end business hotels in major markets. “They’ve been beaten to a pulp.” Values plummet—they “overshot on the upside, now over-correct on the downside.” Distressed owners litter the landscape—myriad late up-cycle deals collapse under adjustable-rate mortgages. “You’ll be able to steal good hotels.”

**Buy Distressed Condos, Second Homes.** Concentrate on prime resort areas where developers overbuilt. Beachfront condominiums in south Florida always bounce back. Despite recent financial reversals, plenty of baby boomers retain ample resources for weekend getaway places and future retirement retreats. You won’t get better deals until the next crash.

**Buy Land.** Home in on “infill sites in top markets,” but be careful of fringe locations. “You must distinguish between good and bad.” And be prepared to hold for five to ten years. Given the feeble development markets, new projects may take time to ramp up. “But land prices may not get much lower . . . ever.”

**Buy or Hold Industrial.** As inventories rebuild, warehouses can recover quickly. Institutional owners, who struggle to assemble large warehouse portfolios, will hunt for product, bolstering values against free fall.

**Hold Office.** Hope long-term leases can bridge the downturn. Prime properties in 24-hour nodes will attract tenants from more problematic B and C properties in a flight to quality.

**Triage Retail.** Infill grocery-anchored strips and fortress regional malls will survive the retreat by debt-plagued consumers. Store chains and shoppers abandon weaker centers and concentrate activity in the strongest malls. Expect more retailer bankruptcies to empty big boxes at some power centers.