

### Recovery & Opportunities - What Must Happen

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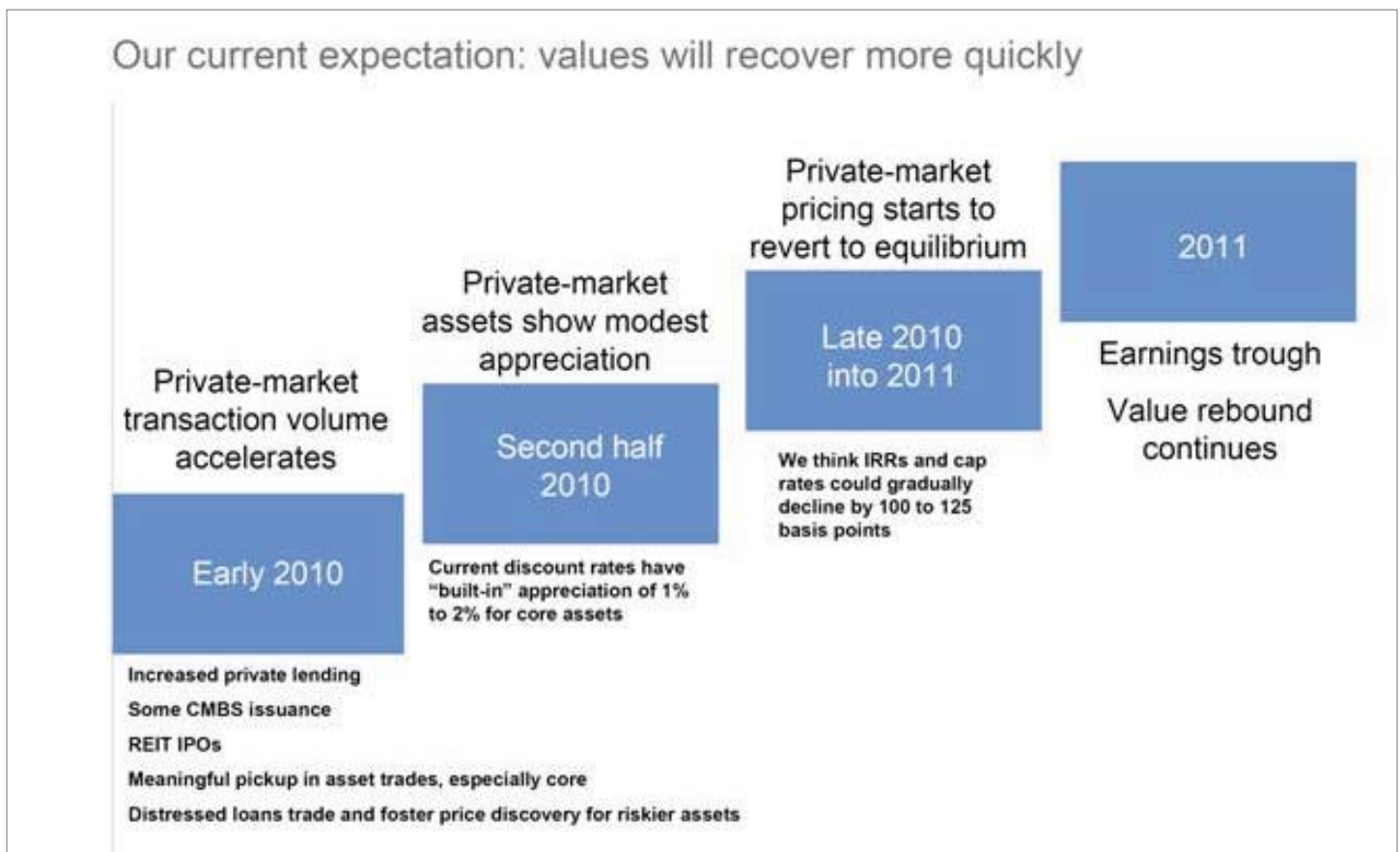
As we reviewed last week's commercial real estate articles and data, we wondered what specific events will have the greatest effect on investment property markets during 2010. J.P. Morgan says that U.S. Commercial Real Estate (CRE) "has the potential to outperform." Their analysts say that CRE values have likely bottomed out with respect to net incomes. In other words, they feel that cap rates have peaked and that there will be movement toward "equilibrium" pricing in late 2010 and early 2011.

*"We expect a relatively deep decline in property income; we believe current appraisal-based property valuations reflect this income scenario; we think private market valuations are below 'fair value'; As a result, we think US CRE has potential to outperform."*

This is a simple and tidy view of the world, and one with which we generally agree, but it begs the question, "what must happen to make it so?"

Unemployment is still the elephant in the room. Whether it is 10% or 17%, the so called U-6 measurement that includes the marginally employed and part-timers who would seek full-time employment, employment is a key to CRE health. Job formation is what will move vacancy rates down from the current 20% to a more normal number in the mid teens. Much of the new job formation has been in the public sector and there are no dramatic signs of private sector hiring. But new jobs traditionally come late in a cycle, which contributes to CRE's traditional late recovery.

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J.P Morgan Chart: Our Current Expectation

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II. There must be more movement in the debt markets. That is, banks and CMBS servicers must more aggressively purge loan portfolios in events of technical and financial default. The larger banks have raised money and now have more cushioning against which to take write-offs while selling commercial real estate positions. CMBS continues to wrestle with the conflicts between foreclosure and preserving the flow of fees, and sometimes, the value of lower tranche bonds. The story of the Peter Stuyvesant apartment complex in New York may be something of a macro-scaled microcosm of the world of CRE debt. As the various interests—debt and equity holders—battle for control of the ultimate form of liquidation and re-capitalization, each party jockeys to save their respective slice of the capital stack and in some cases the fees for management and administration of the debt.

The average recovery for defaulted office loans in Q4-2009 was 58% according to Real Capital Analytics. So, it is no wonder that hope for better conditions continues to be the driver behind lenders' decisions whether to foreclose or not.

III. Sellers must reconcile their expectations with market pricing. If one does not have a need to sell in a down market, one does not. However, there are lots of reasons that owners do need to sell in today's world—lender mandated delevering, cash needs for foundering or developing projects, pending deterioration in a building's income stream, etc. So the pressure must be sufficient to lose the bonds of pride, admit to one's mistakes and move on. Thus far, sales of office properties have been at highly reduced levels. In 2009 \$15.5B of office buildings (over \$5MM in value) traded compared with about \$54B in 2008 and \$211B in 2007. So, it will take more pressure for owners to face into the lower price environment.

IV. Capital markets must continue to increase liquidity. Real estate is an asset class that supports and therefore has been structured to favor leverage. While lenders continue to re-enter the market, it is a very cautious entry. J.P. Morgan predicts that CMBS will re-emerge this year in some form. There will undoubtedly be some greater regulation, perhaps requiring issuers to retain some risk. This is as it should be as the opposite was a prime mover of the financial markets to the edge of disaster.

Banks are still very cautious on real estate. Lenders are focusing on cash flow reliability and coverage of debt service. Pricing is unchanged with spreads over indices being historically high and some banks requiring floors on variable rate loans. Life companies are trickling back to the market as a means of propping up their yields. Most are looking for the very highest quality assets with secure, stable cash flows.

This is a big week for economic and earnings reports. So, the news will be interesting. In any case, successful investment is not a sprint but an endurance race replete with tactics and measured effort. Success is dependent on good execution.

At ground level, we are visiting our selected markets and looking at what we call "non-chronic assets." These are office buildings that have vacancy at or above the current market vacancy but have historically met or exceeded market performance. We hope to develop a watch list of buildings that have the profile we have found to be of interest and whose ownership may be or may become stressed. As always, we encourage you to contact us if you have any questions. Thank you.