Commercial real estate outlook: Top ten issues in 2012

A potential pause in recovery momentum

Contents

Commercial real estate outlook: A potential pause in recovery momentum

Hard on the heels of the United States' economic recession and the simultaneous strengthening of emerging Asian and Latin American markets, the Commercial Real Estate (CRE) industry is seeing an increased focus on diversification into global CRE. While Asia Pacific (APAC) has emerged as a strong driver of global CRE growth, the U.S. continues to attract investments based on size and favorable risk-reward. In general, the U.S. CRE market appears to be on a gradual but uneven path to recovery, with increased capital availability, transactions, and improved fundamentals. Real estate investment trusts (REITs) as an asset class outperformed others, primarily due to higher liquidity, easy access to capital markets, and keen investor interest on the back of low valuations. However, looming debt maturities could act as a potential impediment to CRE's rebound. In addition, the recent backward slide in the global economic situation, particularly in Europe and the U.S., is expected to slow GDP growth and contribute to a lingering high unemployment rate, which may affect CRE recovery in the short term. In addition, the U.S. residential real estate market appears to be years away from a recovery, and the mortgage market faces significant uncertainty amid continuous change. This report, the thirteenth in Deloitte's series on critical issues impacting real estate, takes a closer look at U.S. market trends and developments, with a focus on the outlook for recovery.

The top ten issues for commercial real estate in 2012 are:

1. CRE globalization
2. Macroeconomic fundamentals
3. CRE fundamentals
4. CRE lending
5. Commercial Mortgage Backed Securities (CMBS)
6. Real Estate Investment Trusts (REITs)
7. Private equity
8. CRE deal flow
9. Residential real estate market
10. Residential mortgage market

I hope you find Deloitte's Commercial Real Estate Outlook and our "Top Ten" List informative and insightful. I would appreciate your comments, questions and feedback and the opportunity for me or our partners, principals and directors of Deloitte Real Estate Services to discuss our report with you.

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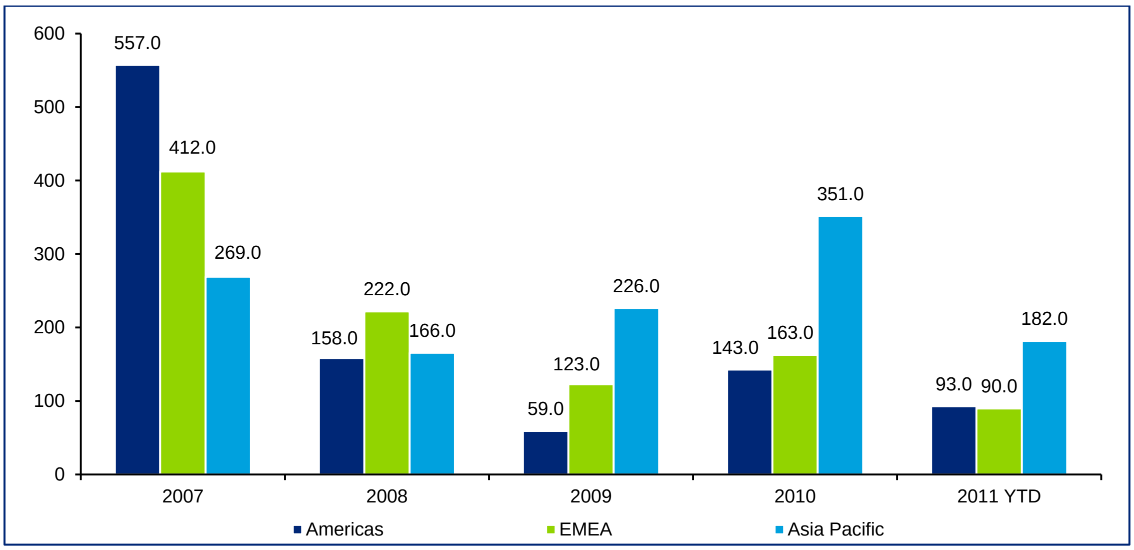
Issue one: CRE globalization

Global CRE continues to gradually improve, despite mounting concerns over sovereign debt and the pace of future economic expansion. The industry has benefitted from a partial rebound in manufacturing activity, increased business spending, and higher capital flows into real estate. Property fundamentals have improved across regions, while development activity remains muted in the U.S., is rising in Europe, and peaking in APAC. The U.S. may witness a moderation in recovery momentum, due to ongoing economic uncertainty; Europe, however, will remain focused on high-quality properties in comparatively stronger markets. APAC may experience a modest tempering of activity due to overheating of the real estate markets and rising concerns around inflation.

Americas region leads growth in global CRE sales volume

Global CRE sales improved in 2011 (Figure 1), as transaction volumes rose for the seventh consecutive quarter, due in large measure to increased liquidity. Global transactions increased 45.8 percent year over year ("YoY") to $178.2 billion in 2Q11. While APAC continued to have the largest share, the Americas region, led by the U.S., reported the highest transaction growth, at 121.6 percent YoY with sales volume of $57.2 billion. In fact, Americas' share of global CRE sales volume stood at 32.1 percent in 2Q11, the highest level since 4Q07.

Figure 1: Improving global CRE volumes: CRE transaction volume by region, FY07–FY11 YTD



Note: 2011 YTD represents data through June 2011.
Source: Real Capital Analytics

Foreign investment in the U.S. rises

The U.S. CRE market continues to draw foreign investor interest as the economy slowly recovers and investors capitalize on attractive opportunities. According to Real Capital Analytics (RCA), foreign investment as a percentage of total investment in the U.S. CRE market rose to 12.3 percent as of July 2011, compared to 8.4 percent during the same period last year. Investors from Canada, Switzerland, and South Korea accounted for 54.6 percent of the total ($11.9 billion as of July 2011). Over the past decade, foreign direct investment (FDI) in U.S. real estate was approximately 10.0 percent of total transactions annually, with other investments made through REITs and co-mingled funds. According to the most recent survey of the Association of Foreign Investors in Real Estate (AFIRE), over 60.0 percent of respondents identified the U.S. as offering the best potential for capital appreciation.

Real estate investment trends in major global markets

Developed Markets: The Canadian real estate market continues to generate significant investor interest due to attractive yields. In contrast, the European market is being affected by the ongoing sovereign debt crisis, with significant flight to quality in the U.K. and modest growth in Germany and France. Among the developed APAC markets, Australia continues to rebound on increased investor focus and enhanced liquidity in credit markets, although investments in Japanese real estate are yet to recover following this year's natural disasters.

Emerging Markets: Despite concerns of overheating and subsequent monetary tightening across major emerging markets (such as Brazil, Russia, India, and China), investment activity will likely remain buoyant due to strong fundamentals and favorable demographics. However, markets in the Middle East and North Africa (MENA) continue to be affected by political and social turmoil.

Outlook

Foreign investments have helped to revive the U.S. transaction market. According to DTZ Research,[i] an estimated $329.0 billion in capital was raised to directly target global real estate in 2011, with 33.7 percent ($111.0 billion) of capital funneled to the Americas. While investors' favorable assessment of risk versus reward continues to add momentum to investments in U.S. CRE, emerging markets will continue to be attractive due to favorable growth and demographic trends.

Bottom Line

Foreign investment continues to be a key component to recovery for U.S. CRE. During 2011, foreign investment helped revive the transaction market, with APAC leading the way. While much of this foreign investment has been focused on high-quality properties in major cities and financial districts within the U.S., there are many opportunities for future investment in tertiary markets that have not been typical focus points for foreign investment. Economic uncertainties, such as the sovereign debt crisis in Europe, may stall near term foreign investment and slow recovery momentum within the transaction market during the latter half of 2011 into 2012.

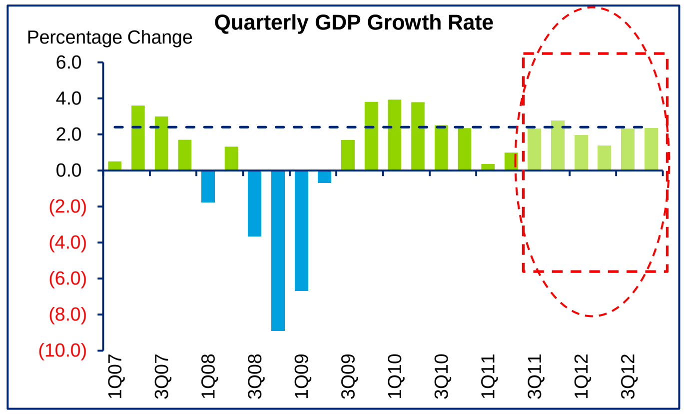
Issue two: Macroeconomic fundamentals

The U.S. economic recovery appears to be stalling following the U.S. sovereign debt rating downgrade by Standard & Poor's, the Eurozone sovereign debt crisis, and the Japanese earthquake. The continued economic uncertainty has resulted in lower consumer confidence and business expectations; consequently, unemployment may remain high, and housing demand could remain muted (Figure 2). Continued slow macroeconomic growth will potentially stem CRE expansion, given CRE lags the broader economy.

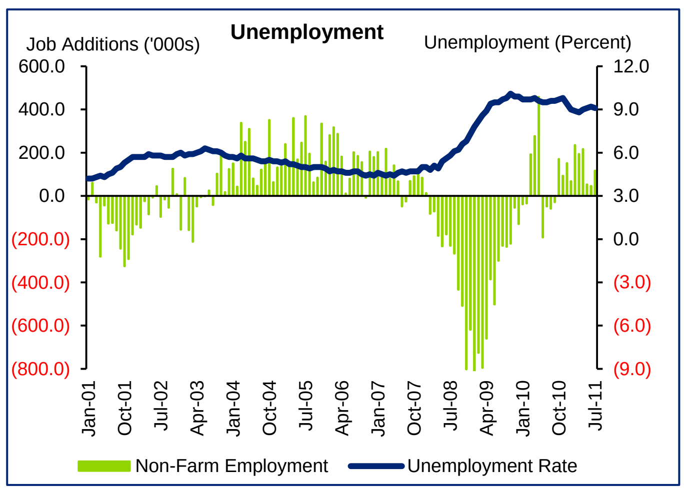
Figure 2: Macroeconomic fundamentals — Performance and outlook

The 2Q11 **GDP growth** of 1.0 percent was higher than the 1Q11 increase of 0.4 percent. However, successive quarters of positive GDP growth remain below expectations due to higher imports, low personal consumption expenditures, and reduced federal government spending.

Outlook: According to Deloitte Research, 2011 GDP growth likely will be 2.5 percent, which is lower than the prior estimate of 2.9 percent and the 2010 level.

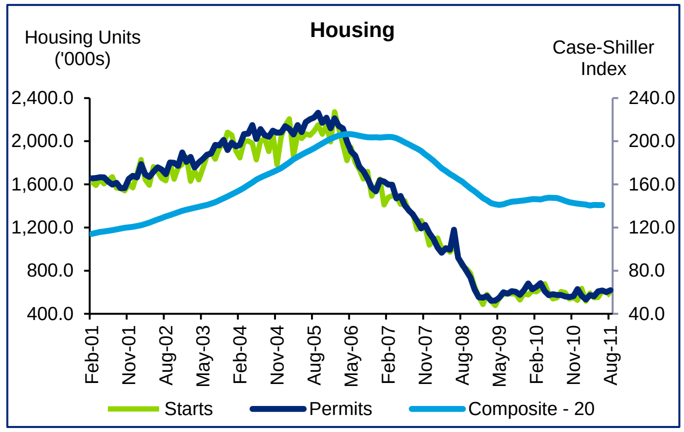


Unemployment continues to trend high, with an insignificant improvement between April and August. Non-farm payroll was unchanged in August compared to a negative 59,000 during the same month in the past year. With the addition of nearly 1.3 million jobs in the past 11 months (Oct 10 – Aug 11), unemployment is slowly improving, yet the economy still needs to add another 7.6 million jobs lost during the recession. In addition, approximately 1 million jobs per year need to be created just to keep pace with population growth.



Outlook: Economic Intelligence Unit forecasts 2011 unemployment at 8.9 percent.

Housing conditions remain poor, with historically low **housing starts** (0.6 million SAAR[1] in August) and declining **home prices** (4.5 percent YoY decline in June). Home prices were affected by high foreclosures and reduced demand after the expiration of the home buyer tax credit.



Outlook: Analysts expect prices to decline further in 2011, due to negative home equity, demand fluctuation, and high foreclosure levels, before bottoming out in 2012. [ii]

Note: Home Price Data is as of June 2011
Source: Bureau of Economic Analysis, Bureau of Labor Standards, Economic Intelligence Unit, S&P Case-Schiller 20-City Composite Index, and Census Bureau

Outlook

Subdued consumer spending, reduced federal spending, and a weak housing market will potentially delay a full-fledged CRE recovery, particularly as job growth has stagnated in the past few months. CRE market participants should consider developing strategies based on realistic expectations of a modest and gradual return to growth as the economy is unlikely to be a short-term catalyst.

Bottom Line

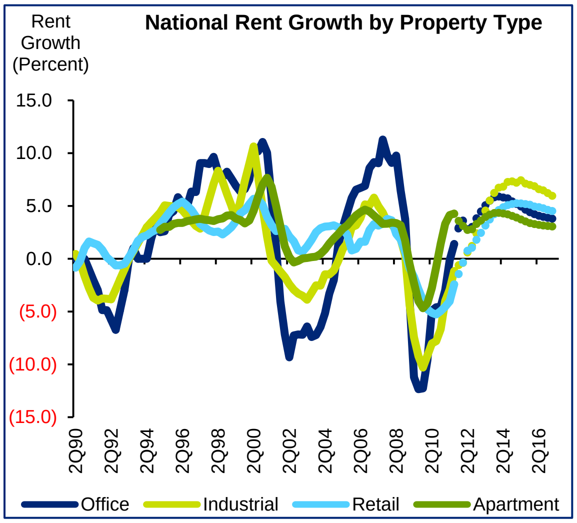
The significant momentum generated within the CRE transaction markets during the first six months of 2011 is in danger of stalling due to weak macroeconomic fundamentals, which are being impacted by the Eurozone sovereign debt crisis, concerns over U.S. fiscal policy, and significant private sector deleveraging. This decline in the overall economic outlook of the U.S. has reduced consumer confidence, which may slow the recovery within the CRE markets; however, high-quality properties in major markets may provide stable, less volatile returns to investors given the current economic outlook.

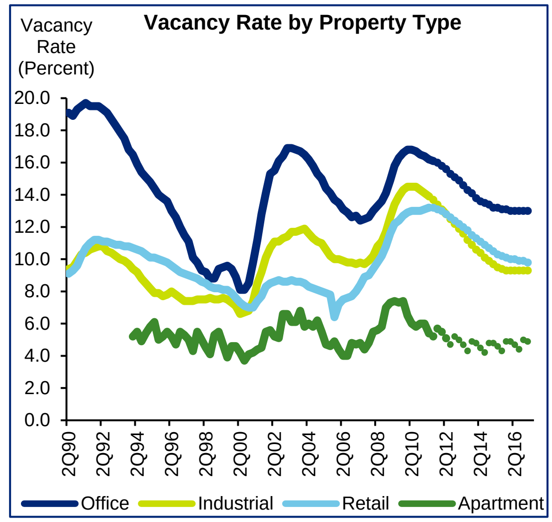
[1] Seasonally Adjusted Annual Rate (SAAR) — A rate adjustment used to remove seasonal variations in data

Issue three: CRE fundamentals

Despite a sluggish, jobless economic recovery, U.S. CRE fundamentals are benefitting from favorable absorption-completion dynamics. Construction activity remains at record lows due to tight underwriting conditions and supply-side adjustments for the contracted demand; therefore, the nation's small improvement in employment is resulting in better-than-expected absorption. There is also a gradual recovery taking place in overall rent and vacancy trends, although its magnitude varies across sub-sectors. The apartment and lodging sectors have posted the most favorable rent and vacancy trends, while retail and industrial appear to be the slowest to recover (Figure 3).

Figure 3: National rent growth and vacancy rate





* Forecasted data from 3Q11
Source: CBRE-EA, 2Q11

Apartment	Rent Growth ↑	Vacancy ↓	Net Absorption ↑

The apartment sector is experiencing favorable supply-demand dynamics, with supply at record lows. In 2Q11, net absorption was a robust 94,807 units (+5.8 percent YoY), while vacancy levels declined 60 bps to 5.4 percent and effective rents increased by a strong 4.1 percent YoY.[iii] New York, Los Angeles, and Washington DC are among the strongest markets. Tight underwriting standards, high foreclosure rates, and stagnant income continue to favor renting and, thus, impact home-buying decisions, despite the fact that the ratio of a median-priced home's monthly principal and interest payment to apartment rent is at record lows. In fact, with improved occupancy, landlords are regaining bargaining power, which is resulting in rent growth in 2011.

Lodging	ADR Growth ↑	Occupancy ↑	RevPAR ↑

Lodging demand continues to recover, driven by improved levels of business and leisure travel. Occupancy and average daily rate (ADR) rose 3.3 percent and 4.4 percent YoY, respectively, in 2Q11, which led to a 9.6 percent YoY growth in revenue per available room (RevPAR).[iv] In fact, 2Q11 marked the fifth consecutive quarter of more than 9.0 percent RevPAR growth. Both full and limited service hotels posted better-than-expected performance, with Miami and San Francisco being the strongest markets. Given limited new supply and higher occupancy levels, hotel fundamentals likely will improve further in 2012.

Office	Rent Growth ⬆	Vacancy ⬇	Net Absorption ⬆

Office fundamentals continued to stabilize amid a flight to quality, as vacancy levels decreased 60 bps YoY to 16.2 percent in 2Q11. Rent decline moderated to 0.2 percent YoY in 2Q11 compared to a 4.9 percent drop in 2Q10.[v] Given limited development activity, the result of low demand, the office sector posted a net absorption of 8.9 million square feet in 2Q11 compared to 4.1 million square feet in 2Q10. [vi] Among major office markets, New York and San Francisco are the strongest, with low vacancies allowing landlords to drive rental rates upward. In contrast, office markets such as Sacramento and Phoenix, which were significantly impacted by the housing crisis, continue to remain the weakest. The sector likely will improve further in 2012 with a gradual decline in vacancy. However, rent growth is likely to remain subdued, with a full recovery expected by the end of 2014.

Industrial	Rent Growth ⬇	Vacancy ⬇	Net Absorption ⬆

Sluggish manufacturing activity resulting from supply-chain disruptions following the Japanese earthquake has slowed absorption in the industrial real estate market. However, it continues to be positive: Net absorption was 26.0 million square feet in 2Q11 compared to a negative 5.7 million square feet in 2Q10.[vii] Despite improved absorption, availability remains high (13.9 percent in 2Q11), which is adding pressure on rent (2.9 percent decline YoY in 2Q11).[viii] Availability should benefit from low construction activity and a gradual increase in absorption of existing space. Hence, while demand will potentially increase modestly in 2011, driven by exports to and imports from Asia, rent growth is likely to improve only in the second half of 2012.

Retail	Rent Growth ⬇	Vacancy ⬆	Net Absorption ⬇

Improvement in retail real estate fundamentals has moderated due to retailers' increased cautiousness. Some retailers have shelved expansion plans, as they are unsure about consumer spending; which has led to negative net absorption of 1.3 million square feet in 1Q11 compared to a negative 0.9 million in 1Q10. However, completion is at a record low, which will temper the effect of lower demand to some extent. Also, margin pressure and cautious consumer spending due to declining home prices indicate that retail sales growth momentum is potentially unsustainable in 2012 — and may pressure vacancy and rents. Further, landlords' weak bargaining power continues to result in substantial flight to quality among retail tenants. Key markets such as New York, Chicago, Boston, and Dallas are unlikely to return to prior peak levels until 2016. In 2Q11, vacancy increased 20 bps to 13.2 percent and effective rents declined 4.0 percent YoY. [ix]

Source: CBRE Econometric Advisors, spring 2011 outlook

Outlook

CRE fundamentals are improving across sectors, although at a varied pace. The drastic drop in development activity amid tight underwriting standards and contracted demand levels may reduce overall CRE activity. Further, fundamentals are unlikely to revert to pre-recession levels in the short term; this may continue to exert a downward pressure on CRE prices. CRE players likely will have to contend with cost discipline and innovative leasing practices to sustain and grow.

Bottom Line

While CRE fundamentals have improved during 2011, this recovery has been more muted than many expected due to continued softness in the economy. The lack of new construction and delivery of new properties has benefited the CRE markets, especially within apartment and lodging sectors, as demand continues to outweigh supply. The delay in the improvement of market fundamentals within the office, industrial and retail sector may prove to be an indicator of an era of reduced expectations and slower growth.

Issue four: CRE lending

Increased investor demand drove a recovery in CRE lending over the past year, which resulted in higher loan originations amid varied financing options. Also, lenders' balance sheets strengthened due to loan modifications and extensions and fewer write-offs, made possible through the "amend and extend" strategy.[2] This strategy is gradually losing steam, though, as lenders focus on permanent resolution of troubled loans amid a pick-up in CRE investment activity.[x] In addition, improved property fundamentals led to lower delinquency and default rates and better loan quality. The CRE debt market still remains challenging, however, with nearly $1.8 trillion due during 2011-2015 (60.0 percent of this amount estimated to be "underwater"[xi]).

CRE loan originations rise

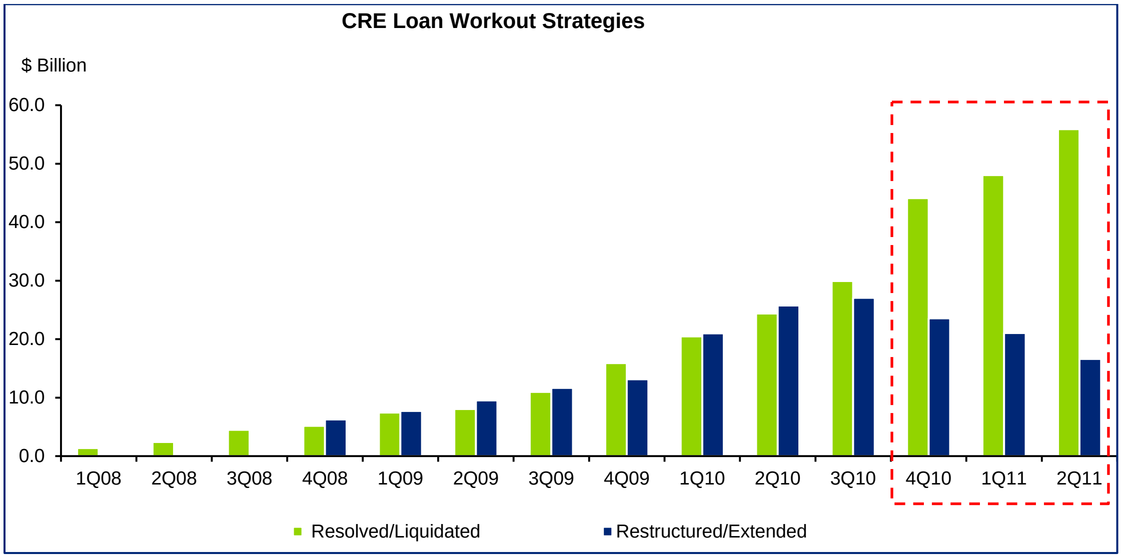
2010 CRE loan originations totaled $118.8 billion (44.0 percent YoY growth), and are likely to increase further in 2011. In 2Q11, the Mortgage Bankers' Association's (MBA) Commercial Mortgage Originations Index rose 107.0 percent YoY to 126.0, its highest level since 3Q08. Life insurance companies continue to lead originations (volume growth of 86.4 percent YoY; MBA origination index was 274.0 in 2Q11 versus 147.0 in 2Q10), followed by government-sponsored entities (GSEs) Fannie Mae and Freddie Mac.[xii] Among property types, the health care sector reported the highest growth in mortgage originations of 140.7 percent YoY in 2Q11 (index value of 130.0 in 2Q11 versus 54.0 in 2Q10), followed by hotel properties.

Credit standards ease slightly; loan treatment bifurcated

Along with higher loan originations, CRE players have improved access to debt and equity capital to meet their refinancing requirements. In addition, a rise in CRE values due to higher transaction activity and a boost in distressed debt resolution through loan sales, refinancing, foreclosures, etc., have led to lenders gradually moving away from the 2010 "amend and extend" strategy. Further, according to the Federal Reserve's 3Q11 Senior Loan Officer Opinion Survey, there was a net 5.5 percent decline in "Domestic Respondents Tightening Standards for CRE Loans," which highlights slight easing of banks' credit standards (specifically for Class A properties). In the 12 months ended June 2011, nearly 77.1 percent of the total loan work outs (or $55.9 billion) were resolutions; the remaining was restructured (Figure 4). Banks are dealing with troubled loans based on size and asset location, modifying larger ones with assets located in distressed regions and liquidating smaller ones. [xiii]

[2] Also referred to by the media as "extend and pretend," and the even less optimistic "delay and pray."

Figure 4: Extend and pretend waning?

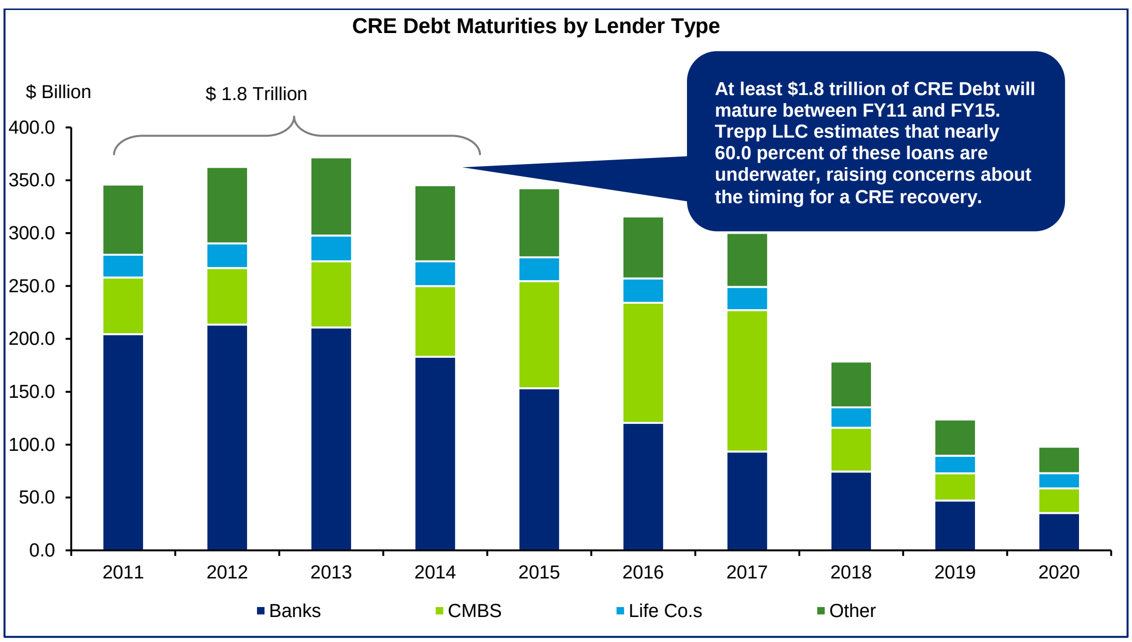


Note: Data pertains to trailing 12-month total
Source: Real Capital Analytics, August 2011

Delinquencies decline; maturities remain a concern

The uptick in loan restructuring and improved property fundamentals have decreased CRE loan delinquencies — 7.1 percent in 2Q11 compared to 8.8 percent in 2Q10.[xiv] However, slower recovery of non-prime properties and continued economic uncertainty are challenges for the $1.8 trillion in CRE debt maturities due by 2015,[xv] despite an improved refinancing market for CRE loans (Figure 5).

Figure 5: Maturities remain a challenge



Source: Trepp LLC, 1Q11 Update

Outlook

Despite improved financing conditions due to availability of capital from increasingly diverse sources, issuance continues to be focused primarily on high-quality, stable assets, especially in gateway cities like New York, Washington, Boston, Chicago, San Francisco and Los Angeles. Also, insurance companies and money center banks continue to compete for better sponsors in strong markets with good assets. Further, smaller regional banks, which continue to face liquidity challenges, hold a high proportion of CRE loans scheduled to mature by 2015, thereby increasing refinancing risk. Prospects for a broad CRE market recovery likely will be enhanced when lenders resume loan originations for “non-trophy” assets and refinancing options increase to respond to growth in debt maturities.

Bottom Line

While lenience by banks and gradual improvement in CRE fundamentals have helped cushion commercial real estate from a more severe downturn, the high level of maturing debt remains a significant barrier to recovery. Debt incurred at the top of the market is now coming due at a time when economic uncertainty has resurfaced and refinancing for non-prime properties in tertiary markets is still difficult. Looming debt maturities of these non-prime properties in the next four years pose an impending threat to CRE capital markets as much of this debt is estimated to be in excess of the value of the underlying real estate or at loan to value levels in excess of current underwriting standards.

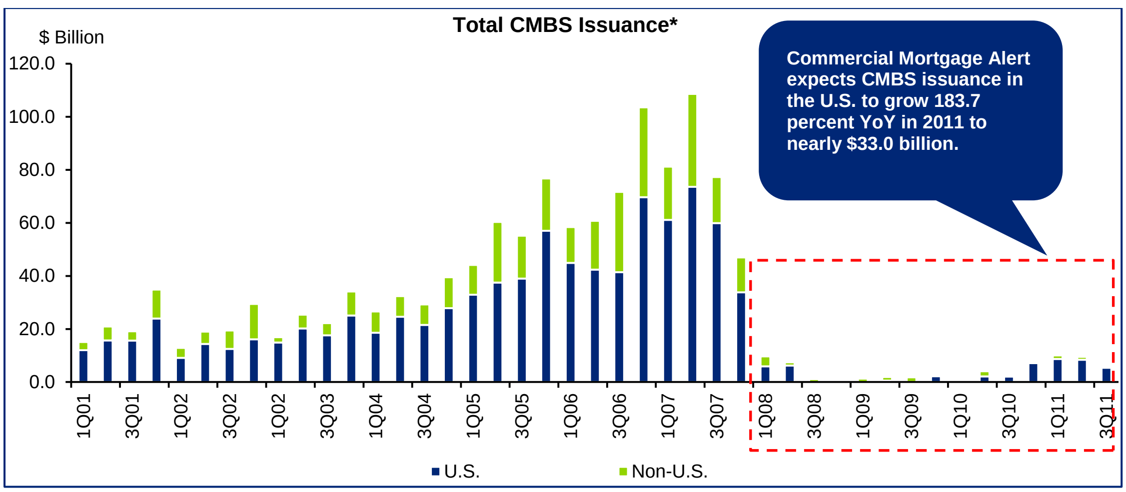
Issue five: Commercial Mortgage Backed Securities (CMBS)

CMBS was the most-affected financing source during the recession as issuance dropped to near zero in 2009. However, in 2010, the CMBS market (coined as CMBS 2.0) showed signs of recovery with issuance of $11.6 billion, which is expected to nearly triple to $33.0 billion in 2011.[xvi] While still below historical highs, investor interest in CMBS is improving and resulting in more financing options for CRE players. The proposed CMBS risk retention rules (where issuers have to retain five percent of the credit risk on new issuance) is expected to have a negative impact on future issuance, although it is unlikely to be implemented before the end of 2013.

Issuance anemic, but signs of revival

The newer conservative CMBS market continues to recover, with YTD 2011 issuance of $22.5 billion (87.8 percent of global issuance) and a YoY growth of 480.8 percent[xvii] (Figure 6). However, the recent credit market volatility likely will have an adverse effect on the pipeline. For instance, J.P. Morgan reduced its CMBS issuance target to $30.0 - $35.0 billion from its prior estimate of $45.0 billion, due to pull-out by borrowers.[xviii] Pricing of new CMBS issuance is being impacted by wide spreads, given fresh concerns about U.S. economic growth. According to Barclays data, relative CMBS yields expanded to 303 basis points in the week ended August 26, 2011 compared to 209 basis points at the end of June 2011. Uncertainty in the credit markets and rating volatility continue to create loan pricing instability. Loans are being quoted with less frequency, and loan spreads continue to be subject to change. Issuers have demonstrated an unwillingness to take the spread risk associated with the uncertainty.

Figure 6: Total CMBS Issuance



* 3Q11 CMBS Issuance data, as of August 2011
Source: Commercial Mortgage Alert, August 2011

Pace of delinquencies slows

While CMBS delinquency rates remain high at 9.5 percent as of August 2011, the pace of delinquencies has significantly moderated. For instance, between January and August, delinquencies have increased just 20 basis points (9.3 percent to 9.5 percent) compared to 290 basis points (6.0 percent to 8.9 percent) during the same period last year. In the future, the rise in delinquencies may continue to be slow amid improved refinancing options. In fact, Fitch lowered its 2012 estimate of CMBS delinquencies to 10.0 percent from 12.0 percent.[xix] Further, the bulk of CMBS maturities are due in 2015-2017, with an average annual figure of $116.3 billion compared to $59.1 billion in 2011-2014.

Outlook

Recovery in the CMBS market is potentially stalled due to credit market volatility and the recent cancellation of ratings of two new issuances by Standards & Poor's. In addition, CMBS spreads widened considerably in June and July, which has added to issuer reluctance and pull-back of a few potential issuances. However, once the market returns to normalcy, CMBS issuance should pick up. This will be important, as the re-emergence of the CMBS market is the factor having the greatest impact on the availability of debt capital going forward.

Bottom Line

CMBS was the most affected financing source during the recession as a result of a central role these securities played in the financial crisis. The increase in CMBS activity during 2010 and the first half of 2011 was a promising sign of recovery for the CRE industry; however, the recent credit market volatility has already resulted in failed CMBS issuances and is expected to have an adverse effect on the overall pipeline. The future of the CMBS market will play a significant role in the ultimately recovery of CRE in the U.S.

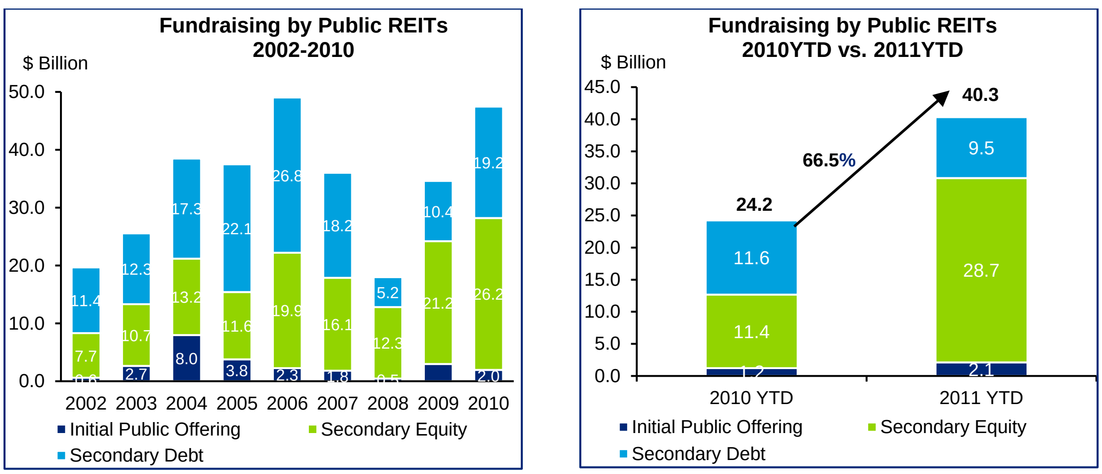
Issue six: Real Estate Investment Trusts (REITS)

The REIT recovery began much earlier than that of the underlying CRE fundamentals, predominantly due to the opening of the capital markets. Public REITs used this to their advantage: they actively raised capital and deployed it to deleverage balance sheets. Since then, REITs have used excess cash for opportunistic and strategic acquisitions, especially as development activity remains low. REITs emerged as one of the key transaction drivers in 2010, with $24.7 billion in acquisitions (18.0 percent of total transactions compared to 10.0 percent in 2009).[xx] As an asset class, REITs continue to outperform many traditional asset classes.

Robust fundraising and investments

Taking advantage of relatively easy access to capital (both debt and equity), REITs raised about $82.1 billion in capital during 2009-2010[xxi] (Figure 7). REITs used this capital to reduce leverage, which was down to 39.8 percent in 2010 compared to 66.3 percent in February 2009.[xxii] The resulting strength in balance sheets allowed REITs to focus on acquisitions, with $64.2 billion during 2009-1H11. Consequently, REITs emerged as one of the most active buyers of commercial property and increased their share in acquisitions from 10.0 percent in 2009 to 21.3 percent in 1H11.[xxiii]

Figure 7: Rise in REIT fundraising



* YTD is through July 31, 2011
Source: NAREIT, August 2011

Rise in REIT mergers and acquisitions (M&A)

Along with conducting property transactions, REITs have become active in M&A. In 2011, REITs completed large M&A deals in the health care and industrial sectors. The most prominent M&A deals include the $16.5 billion Prologis — AMB Property Corp, and $7.0 billion Ventas — Nationwide Health Properties transactions, announced in February and January, respectively. Moreover, asset management firms have also shown interest in public REITs. For instance, Brookfield Asset Management acquired 38.8 percent in General Growth properties for nearly $4.3 billion (in two transactions[3]), and Blackstone Group acquired the U.S. property portfolio of Australian shopping center REIT, Centro Properties, for $9.4 billion in February. Analysts remark that large future REIT M&A deals likely will be limited, although given the increase in capital availability and minimal development activities, REITs may target select smaller companies which are a strategic fit to drive future growth.[xxiv]

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[3] In November 2010, Brookfield Asset Management, Canada, acquired a 27.0 percent stake in GGP for $2.6 billion. Thereafter, in January 2011, it acquired an 11.8 percent stake for $1.7 billion.

Higher returns than competing asset classes

Following negative returns during the recession (Figure 8), REITs rebounded in 2009 with attractive returns of 27.6 percent[4] and continued the trend in 2010. In 2011; however, REIT returns have been lower due to underperformance of broader equity markets amid continued economic uncertainty. Despite modest returns of 3.4 percent, as of August 29, 2011, REITs still outperformed most asset classes as investors seek portfolio diversification and superior inflation-hedged returns.

Figure 8: REITs outperform other investment classes

Asset Class	FY07	FY08	FY09	FY10	FY11 YTD*
Private Real Estate (NCREIF Property Index)	15.9	-6.5	-16.9	12.6	7.3**
Public REIT (All REIT Index)	-17.8	-37.3	27.5	27.6	3.4
DJIA	6.4	-33.8	18.8	11.0	-0.3
S&P 500	5.5	-37.0	26.5	15.1	-2.5
NASDAQ	9.8	-40.5	43.9	16.9	-3.4
Russell 2000	-1.6	-33.8	27.2	26.9	-6.8

* YTD is as of August 29, 2011
** As of June 30, 2011
Source: NAREIT, August 29, 2010

Outlook

REITs are well-positioned due to the improvement in property fundamentals and market dynamics as well as their relative advantage as an alternative investment class. However, unlike pre-recession times, growth prospects of REITs are now heavily dependent on mergers and acquisitions and driving increases in rental income, due to limited development activity. Although there is no certainty about the relative outperformance of REITs over competing asset classes, an improvement in the broader economy likely will be the key to sustained growth for this asset class. In the long term, REITs may benefit from global expansion as emerging markets implement REIT provisions within their tax codes to facilitate real estate investment activity.

Bottom Line

The performance of REITs has been a bright spot within the CRE industry over the past two years. Improved access to capital drove significant transaction growth and REITs were able to acquire prime properties within major markets at favorable pricing due to the overall market distress. REITs continue to outperform the major markets and are favorably positioned during this economic uncertainty. REIT owners are expected to focus on property operations, leasing and property management; as well as mergers and acquisition opportunities, in order to add value until a full-fledged economic recovery resumes.

[4] Returns of FTSE/NAREIT All REIT Index

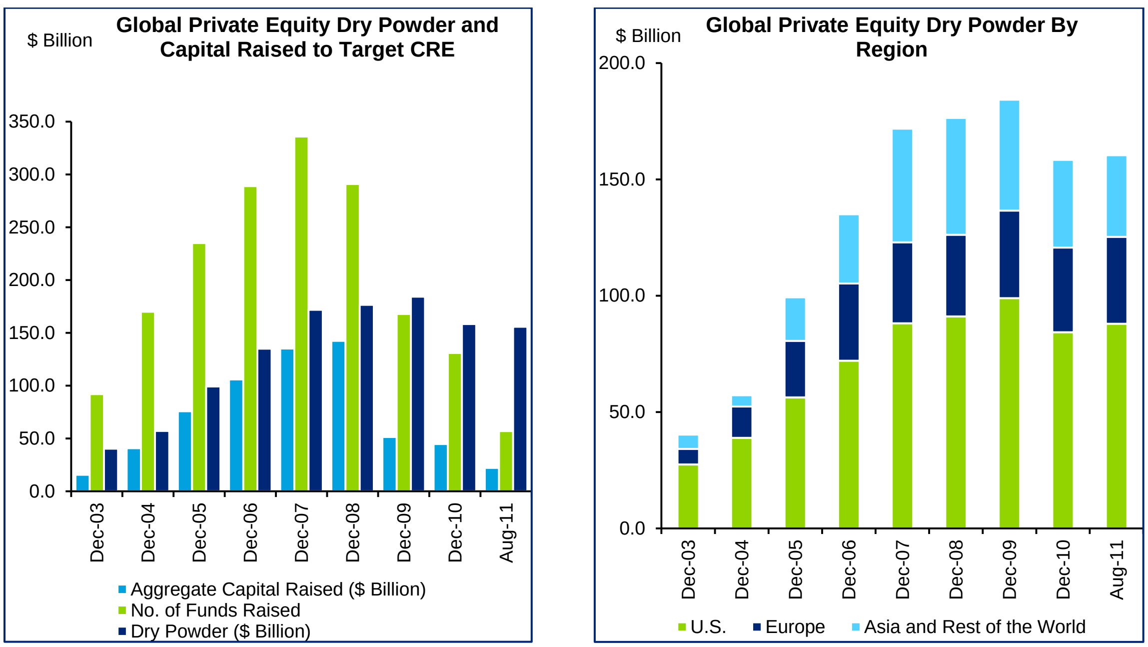
Issue seven: Private equity

Another CRE financing source — the private equity real estate (PERE) market — was adversely affected by the recession, which resulted in lower deal volumes and little fundraising. Since 2009, there has been improvement, albeit at a slower pace than pre-recession levels. However, there remains a significant amount of capital raised yet to be deployed, given concerns about property values and significant investor competition on high-profile opportunities brought to market. In addition, renewed concerns about U.S. economic growth may impact investments, as investors may choose to remain on the sidelines.

Moderate fundraising; ample dry powder

During January to August 2011, global PERE fund raising totaled $22.2 billion, which is significantly lower than the $44.7 billion garnered during 2010 (Figure 9). Of this, U.S. fundraising was $15.3 billion compared to $27.1 billion during the same period.[xxv] However, according to a July Preqin survey, 72.0 percent of alternative investment consultants are expected to significantly or slightly increase recommended capital commitments to real estate in 2011. This is an improvement from the February survey, in which only 45.0 percent of consultants said they recommended additional capital commitments to real estate in 2011. Global dry powder levels declined to $155.8 billion (as of August) compared to $158.4 billion in 2010. In the U.S., dry powder increased modestly to $85.8 billion (as of August 2011) compared to $84.3 billion at December 2010, which highlights the substantial capital readily available for real estate investments.

Figure 9: Global private equity dry powder and capital raised to target CRE



Note: As of August 2011
Source: Preqin, September 2011

North America distressed real estate: preferred source of investment

The May 2011 Preqin survey of 70 alternative investment consultants showed that their preferred investments include opportunistic and distressed real estate. These assets classes had an average ranking (highest) of 3.7 and 3.6, respectively, on a scale of 5, with 5 being the most attractive. Of the $44.7 billion PERE capital raised in 2010, 32.0 percent and 22.0 percent were allocated to opportunistic and distressed real estate strategies, respectively.

Also, given consultant and investor belief that the North American real estate market is yet to fully recover, and with significant capital raised for deployment to distressed opportunities, the region is likely to see maximum PERE investments. According to the May 2011 Preqin survey, 68.0 percent of respondents said they believe that the real estate market in North America is yet to fully recover. Asia is the next potential preferred destination.

Outlook

The PERE market is still recovering, despite the expected increase in investment activity. According to a recent Preqin survey, property values and economic and market volatility are key concerns and are acting as an impediment to full recovery of real estate investment. Post-recession, PERE returns lag the overall private equity (PE) space. According to Preqin, in 2010, PE and PERE funds posted a net internal rate of return (IRR) of 18.8 percent and 4.7 percent, respectively, which indicates the comparative lower performance of the asset class. In contrast, during the pre-recession period, PERE reported stronger returns and outperformed the PE space in 2005-06. In 2006, PE and PERE returns were 29.1 percent and 42.6 percent, respectively.

Bottom Line

Although the overall level of PERE dry powder has decreased modestly due to recent investment activity and slower fund raising efforts, there is still a significant amount of capital on the sidelines. PERE investment has been primarily focused on major markets, as there has not been a significant level of investment in tertiary markets. Current economic uncertainties may slow the deployment of capital, as PERE funds will closely monitor distressed opportunities in the event that property fundamentals stall due to the current economic environment.

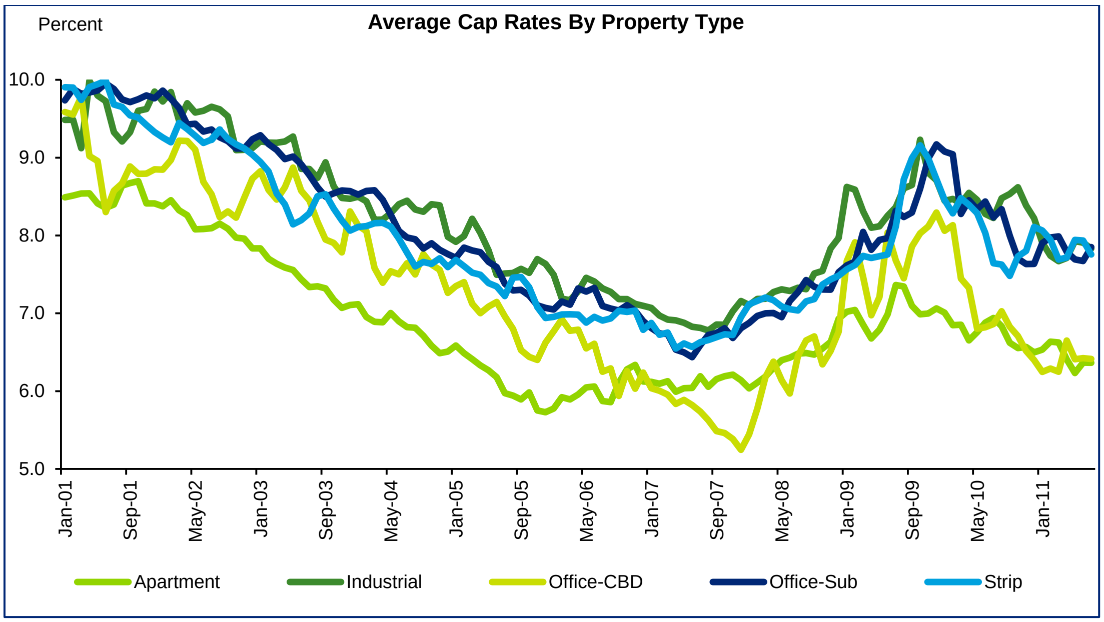
Issue eight: CRE deal flow

A bright spot in the CRE recovery process is transaction activity, driven by REITs and distressed deals. A gap exists between buyers' capacity and sellers' expectations, but lenders and special servicers have brought distressed property to market. Investors also have capital to tap these opportunities. In addition, with easier access to capital, REITs raised nearly $82.1 billion in 2009-2010 to fund acquisitions.[xxvi]

CRE pricing recovers

Property prices continue to rise, driven by increased capital availability and improved fundamentals. As of August 2011, Green Street Advisors' commercial property price index (CPPI) increased 46.0 percent from the lows of mid-2009 and was just 9.9 percent below the 2007 peak. Cap rates have continued to compress across all property types and are near 2005 levels (Figure 10).

Figure 10: Cap rates decline

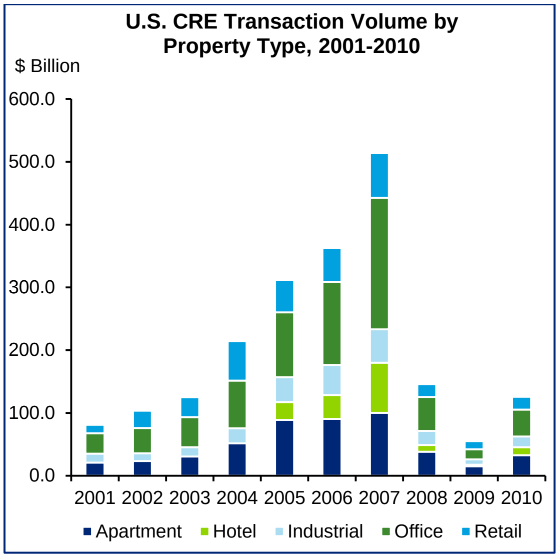


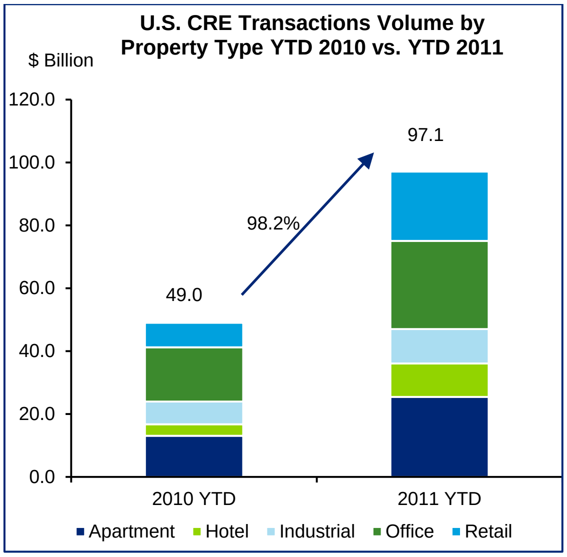
Source: Real Capital Analytics, July 2011

Transaction volumes continue to rise

In 2010 and 2011 YTD (as of July), U.S. CRE deal volume rose 128.3 percent and 98.2 percent YoY, to $125.7 billion and $97.1 billion, respectively, led by office properties[xxvii] (Figure 11). Most transactions were for high-quality assets, especially those with stable rent rolls in top-tier cities, while increased capital availability and competition have resulted in investor interest in select tertiary markets. For instance, in 1H11, U.S. office-suburban markets reported property sales volume of $12.0 billion, nearly equal to $12.4 billion in office-CBD markets.[xxviii] Overall, this positive momentum bodes well for the long-term recovery of the U.S. CRE markets, despite the fact that 2010 transaction volume was only 24.5 percent of the 2007 peak. However, transaction growth appears to be moderating in the second half of 2011, as global economic uncertainty begins impacting investor appetite and real estate debt availability and pricing.

Figure 11: Rise in transaction activity



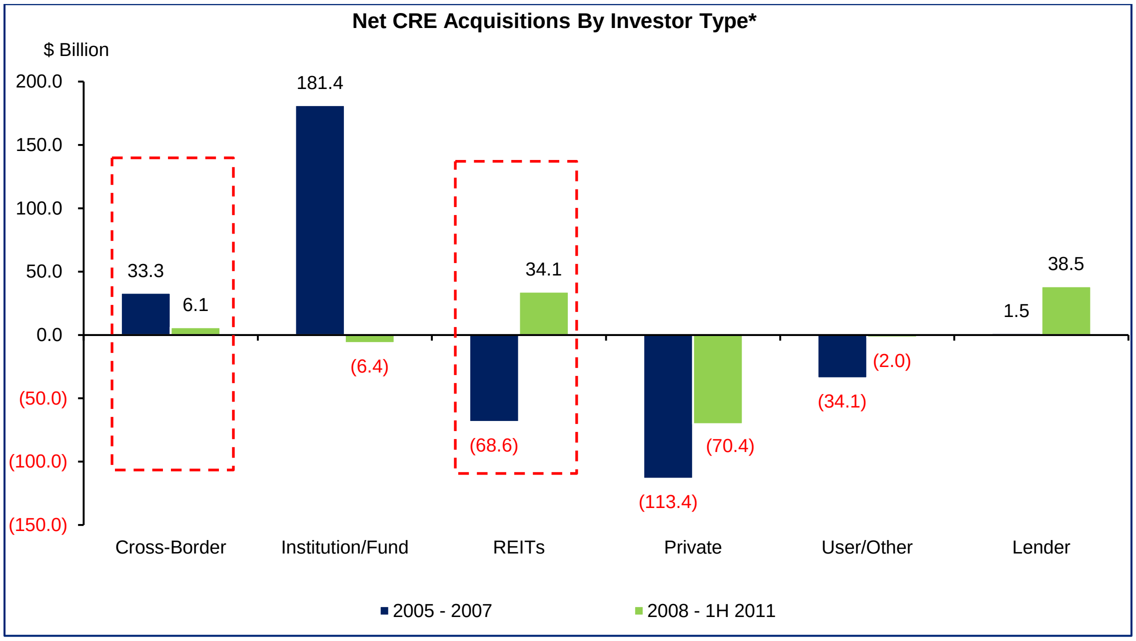


* YTD is through July 2011
Source: Real Capital Analytics, August 2011

REITs and foreign investors drive transaction recovery post-recession

Since 2008, private and institutional investors have been the most active buyers and sellers of U.S. traded commercial property. However, REITs and foreign investors have significantly impacted investment recovery, with net positive acquisitions of $34.1 billion and $6.1 billion, respectively (Figure 12).

Figure 12: REITs and foreign investor's record net positive acquisitions

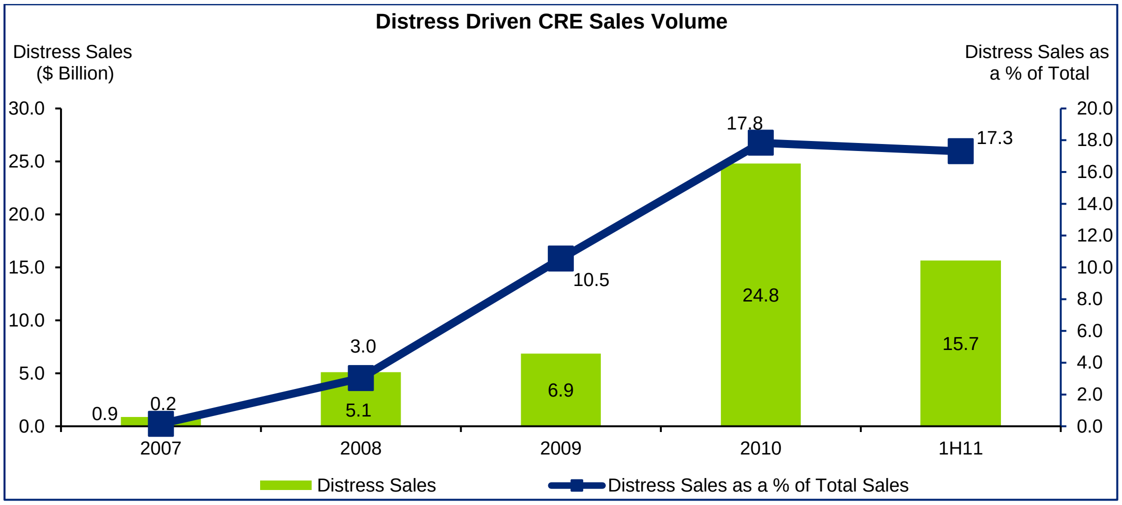


Note: Analysis excludes the Blackstone/Centro portfolio that sold in June '11 for $9.2B
* Data includes valid sales as well as transfers such as foreclosures and deed-in-lieu
Source: RCA, August 2011

Distressed assets: another key transaction driver

Distressed property transactions continue to rise due to improved financing conditions and favorable convergence of bid/ask spreads. During the first half of 2011, distress-driven sales increased 125.3 percent YoY to $15.7 billion and comprised 17.3 percent of total U.S. CRE sales[xxix] (Figure 13). However, distressed assets are close to a peak, as new additions to distressed inventory fell for the sixth consecutive quarter in 2Q11 to their lowest level since 3Q08. Total loan workouts also exceeded new distress additions in 1H11. Despite this, with nearly $182.6 billion in troubled assets, transaction opportunities still exist.[xxx]

Figure 13: Distress continues to be a transaction driver



Source: Real Capital Analytics, June 2011

Outlook

Growth in CRE transaction activity is anticipated to continue with increased capital availability. However, investors are expected to be cautious and lenders are unlikely to return to pre-recession credit standards: According to CBRE Capital Market Lender Forum, the average inception loan-to-value (LTV) of commercial property loans at the 2007 market peak was 75.0 percent compared to 62.0 percent in 2011. REITs are expected to dominate transaction activity in 2012, albeit with increased competition from other investors such as institutions and equity funds. In addition, distress transactions will likely continue in 2012, due to an increase in REO[5] as lenders seek to permanently resolve troubled mortgages. However, a broad-based transaction market recovery, requiring increased demand for "non-trophy" assets, may be delayed in light of current economic uncertainty.

Bottom Line

The increase in deal flow during 2010 and the first half of 2011 appeared to be sign that the markets for CRE were on the road to recovery, especially for high quality properties in major markets. In addition, growth in distressed transaction activity was a leading driver of increased transaction activity as more lenders brought troubled loan and property portfolios to market. The hope of return to peak transaction levels has been muted due to recent economic uncertainties, and the impact of the Eurozone sovereign debt crisis and the current U.S. economic uncertainty will be a major factor in 2012 transaction volume.

[5]**REO** signifies properties or assets lenders have taken back through foreclosure. The property is now **R**eal **E**state **O**wned by a lender.

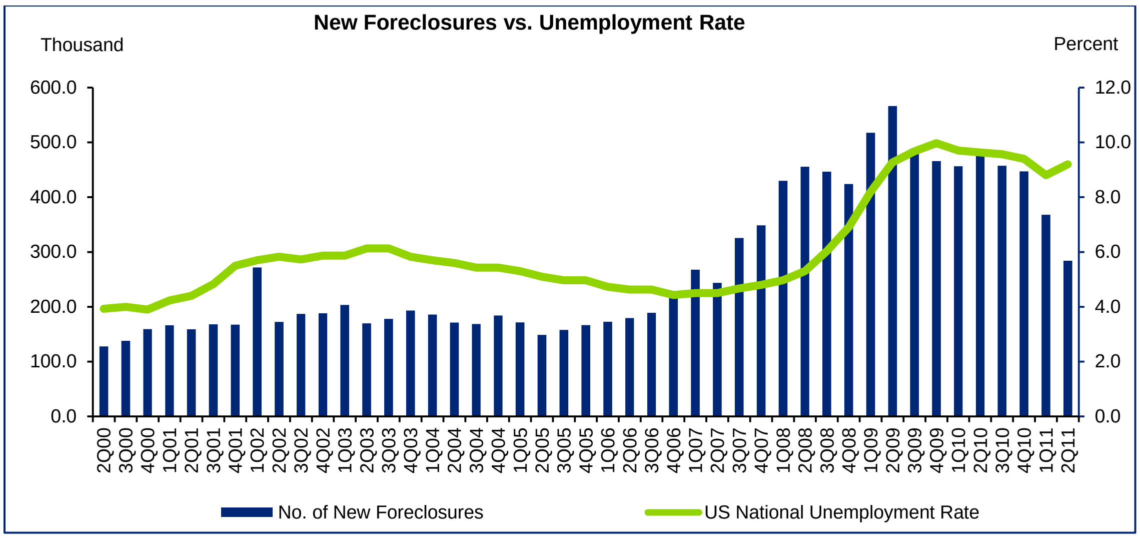
Issue nine: Residential real estate market

Housing, the major driver in prior economic recoveries, continues to be a weak link in the economy's revival from the recent recession. Key measures of the sector's health have yet to recover. Negative factors include elevated supply, weaker single-family home sales, and falling home prices, all of which are occurring against the backdrop of persistently high unemployment.

Temporary decline in foreclosures

Foreclosures in 2Q11 fell below 300,000 to reach their lowest point since 2Q07, as lenders slowed on new foreclosures after widespread criticism about sketchy documentation and a "robo-signing"[6] controversy. The decline may be temporary, though, as over a million homes are estimated to be in the foreclosure pipeline.[xxxi] In addition, mortgage defaults will potentially trend upwards due to sustained levels of high unemployment (Figure 14). While a delay in foreclosure actions and the implementation of government initiatives such as the Home Affordable Refinance Program (HARP)[7] will allow a subset of borrowers to avoid or delay foreclosures, analysts believe that a rising backlog of foreclosed inventory and postponement of foreclosure may prolong the difficult housing situation.

Figure 14: Lower foreclosures and high unemployment



Source: Source: Bureau of Labor Statistics; NY Fed. Data through Q2 11

Home sales continue to languish

U.S. home sales have declined in four of the five years since the housing bubble burst in 2006. In 2011, sales have trended lower (Figure 15), despite attractive home prices and low interest rates, due to tight credit standards and weak consumer confidence. While existing home sales rose 7.7 percent in August 2011, driven by distressed assets, the outlook remains grim in light of fragile demand. Further, new single family home sales continue to underperform (they declined for the fourth consecutive month in July) due to tough competition from cheaper existing homes and a

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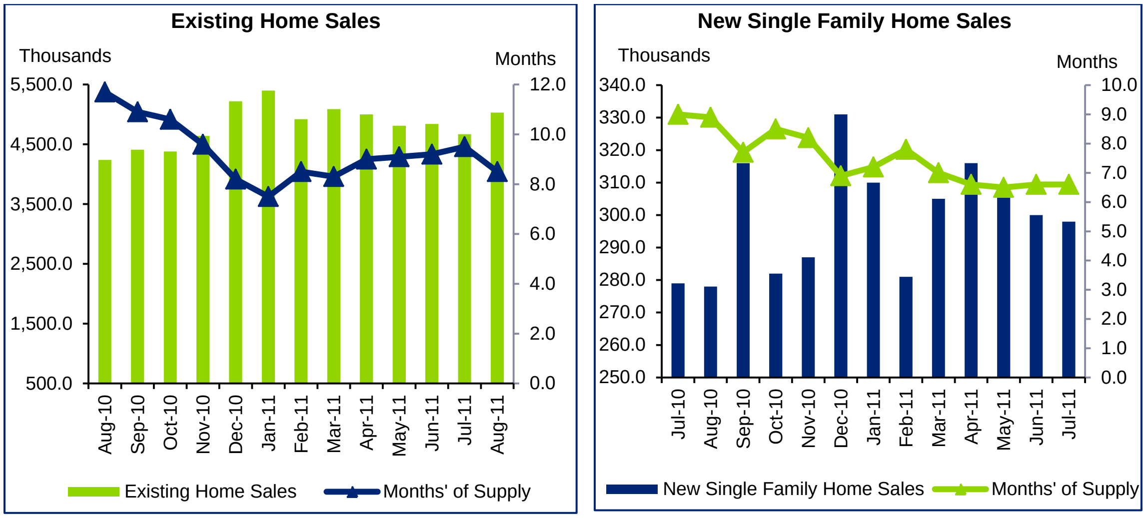
[6] "Robo-signing" is a term used to describe the robotic process of the mass production of allegedly false and forged mortgage assignments and other legal documents related to foreclosures.

[7] HARP is designed to help homeowners with underwater mortgages, through reduction of monthly payments or replacement of a riskier loan structure, such as an interest-only mortgage with lower and more fixed-rate mortgage.

substantial inventory of unsold homes. Months' supply was unchanged in July, remaining at 6.5 months.

Figure 15: Home sales trend lower in 2011

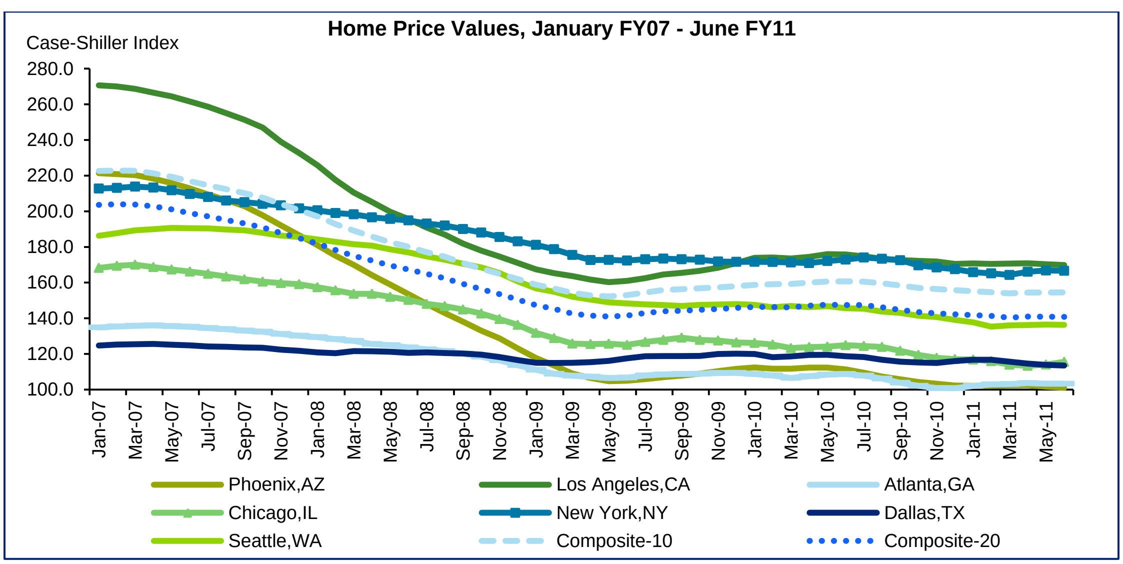


Note: Home Sales are at Seasonally Adjusted Annual Rate (SAAR)
Source: National Association of Realtors (NAR), September 2011; Census Bureau, August 2011

Home prices under pressure

Home prices continue to be impacted by an unfavorable demand-supply scenario. Many first-time buyers are unable to take advantage of historic low prices due to tight credit norms, whereas creditworthy buyers continue to postpone purchase decisions based on falling prices. Home prices were either unchanged or down in June 2011 from the prior month for all seven of the major metro areas surveyed by Standard & Poor's (Figure 16). According to a survey conducted by MacroMarkets LLC, economists expect home prices to rise a modest 1.1 percent a year through 2015.[xxxii]

Figure 16: Home prices decline



Source: Standard and Poor's, July 2011

Outlook

For a residential real estate recovery to begin, it is likely that the inventory of foreclosed homes and those in the pipeline will need to be cleared, and the supply of single family homes reduced. The erosion of home equity and resulting foreclosure risk is a “double whammy” to new home construction as it potentially creates supply which may compete directly with newly built homes, and it also has the indirect result of reducing the move-up ability of those who might otherwise use their existing home equity to buy a newly built home. For home prices to move upward in the future, supply will have to fall to a market-clearing level or the point at which demand equals supply. For the market to reach this clearing point, it is likely that unemployment will need to begin to decline, which could potentially spark home sales.

Bottom Line

The residential real estate market continues to be a significant impediment to economic recovery in the U.S. Declining home values are negatively impacting consumer confidence and spending, and lack of new home construction activity has had a significant impact on unemployment. Until the overall housing market improves, there will be concerns about the U.S. economic outlook, and yet it will likely take a strong economic recovery to drive improvement in the housing market. Government programs have been unable to stimulate the housing market and although foreclosures have decreased in recent months, there is still downward pressure on home values.

Issue ten: Residential mortgage market

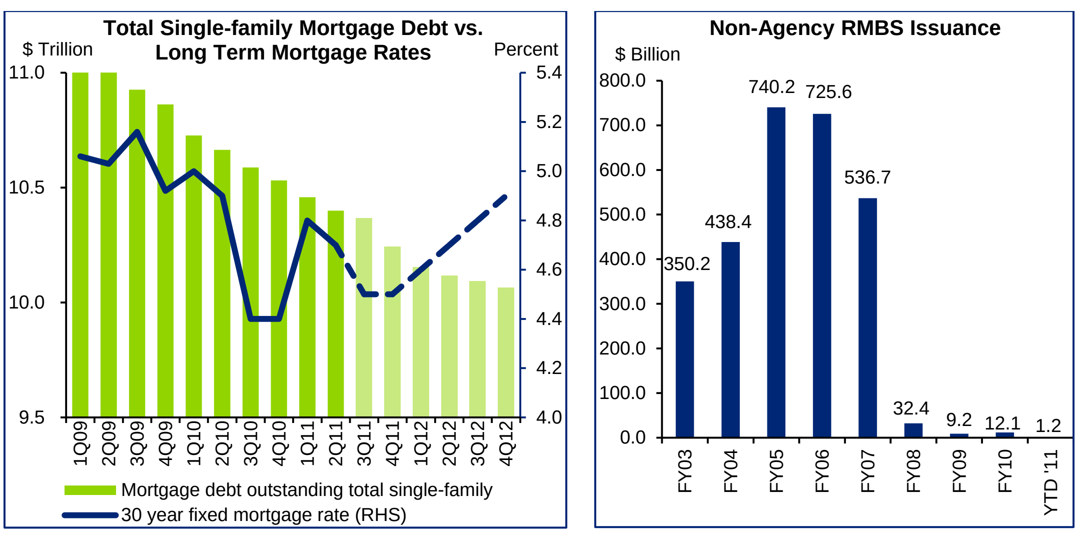
The residential mortgage market was the root cause of the sub-prime crisis and a major contributor to the 2008 economic recession. In September 2011, the Federal Financial Institutions Examination Council (FFIEC) reported there were 12.9 million mortgage applications in 2010 resulting in about 7.9 million loan originations. This is less than half the 2005 levels. While mortgage debt levels continue to drop, new non-agency securitization issuances remain at record lows. Further, delinquencies hover at historic highs despite several bank and government loan modification efforts. To restore the market, the government has announced numerous measures, such as strict underwriting standards, reorganization of the GSEs (Fannie Mae and Freddie Mac), and introduction of alternate finance mechanisms (covered bonds). Consequently, despite stabilization of the situation, the market is yet to demonstrate growth, which has resulted in considerable speculation about its near- and long-term viability and impact on the U.S. economy.

Record low new issuance; continued decline in outstanding mortgage debt

Issuance of residential debt remains low and has been primarily agency-driven, with non-agency residential mortgage backed securities (RMBS) at historic lows: $12.1 billion (total: $1.7 trillion) in 2010 compared to an average $558.2 billion (total: $2.1 trillion) during the 2003-2007 housing peak. YTD 2011 performance is dismal, with non-agency RMBS issuance of $1.2 billion and a total of $1.1 trillion[xxxiii] (Figure 17). The low issuance level is due to reduced demand and increased litigations by government, banks, and private investor groups. In addition, non-agency issuers are being forced to enact high levels of due diligence and disclosure to satisfy wary investors.

2Q11 marked a milestone, as total single-family mortgage debt outstanding declined for the tenth consecutive quarter. Fannie Mae projects debt will continue to decline, as the 30-year fixed mortgage rate rises. It reports mortgage debt is likely to contract at an average rate of 2.1 percent from 3Q11 through 4Q12. Interest rates are forecast to steadily increase, with the 30-year fixed mortgage rate climbing from 4.7 percent in 2Q11 to 4.9 percent by 4Q12.

Figure 17: Mortgage debt to fall amid expected rise in interest rates; decreased RMBS issuance



Note: Forecasted data from 3Q11

Source: Actuals: Census, Bureau of Labor Statistics, Federal Reserve, Mortgage Bankers Association, and National Association of realtors. Forecasts: Fannie Mae Economics and Mortgage Market Analysis, August 2011

Note: YTD is as of August 2011

Source: Securities Industry and Financial Markets Association (SIFMA), September 2011

Stringent underwriting standards; delinquencies remain high

Underwriting standards for residential real estate loans remain stringent. According to the 17th annual underwriting survey of the Office of the Comptroller of Currency, residential real estate loans, including construction, experienced the most tightening in underwriting standards during the 2011 survey period. Of 48 banks surveyed, 40.0 percent continue to tighten underwriting standards and the standards remain unchanged for approximately 52.0 percent (tightened for several years).[xxxiv] Further, banks continue to hold large amounts of residential real estate loans on their balance sheets — over 35.0 percent of total loans, on average, for the top five U.S. banks. The preferable option for banks dealing with troubled or maturing debt with significant collateral valuation issues is to restructure and extend existing debt. Delinquency (seasonally adjusted) rose sequentially in 2Q11 for residential real estate loans at commercial banks to 10.5 percent from 10.4 percent in 1Q11, and improved YoY from 11.2 percent in 2Q10.[xxxv] Overall, according to MBA, the delinquency rate on one-to-four unit residential properties was 8.4 percent in 2Q11, up 12 basis points and down 141 basis points, sequentially and YoY, respectively. MBA expects delinquencies to worsen further, particularly due to high unemployment levels.[xxxvi]

A Stricter regulatory environment[xxxvii]

Heightened regulatory scrutiny is an outgrowth of lessons learned from the federal regulators' horizontal review of 14 major banks and two residential loan servicers, Freddie Mac and Fannie Mae, and their mortgage foreclosure processes. Subsequent enforcement actions and consumer protection mandates have been shaking these banks and mortgage operations to their core, prompting them to significantly rework procedures across their mortgage products' life cycle. Further mandates and restrictions via the Dodd-Frank financial reform legislation are expected in the coming months. Concurrently, regulators are changing the way that they examine and supervise lending institutions: regulators are much quicker to put institutions under enforcement actions for questionable lending and foreclosure processes. In February 2011, regulators announced an eventual wind down of Fannie Mae and Freddie Mac and increased participation from private lenders. Along with a focus on affordable housing to boost loan demand, the regulators have introduced legislation for developing an alternative funding source in the form of covered bonds. The U.S. Covered Bond Act of 2011, which was introduced in the House on March 8, is in the second step of the legislative process and is expected to be passed by the end of 2011 or early 2012.

Outlook

According to industry participants at Deloitte's May 2011 Distressed Debt and Assets Symposium, a sustained recovery in the residential mortgage market is highly dependent on how mortgage regulations continue to evolve and how the market acts in response. The panelists believe that the recent lessons learned indicate that it is time to take a fresh look at how the industry handles its mortgage underwriting and foreclosure processes, not only for the regulators' benefit but for mortgage lenders' own purposes, particularly when activity peaks.

Bottom Line

The residential mortgage market is transforming due to shifts in the regulatory environment, prolonged economic pressures, and the entrance of new market participants. The residential mortgage market will continue to evolve significantly over the next few years as a result of the regulatory environment, the impact of declining home prices, foreclosure practices and troubled loan resolution.

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[vi]CBRichard Ellis — Econometric Advisors (CBRE-EA), 2Q11
[vii]CBRichard Ellis — Econometric Advisors (CBRE-EA), 2Q11
[viii]CBRichard Ellis — Econometric Advisors (CBRE-EA), 2Q11
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