2012–2013

Commercial Real Estate Forecast: Opportunity is Knocking

By: Ray Alcorn

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About the author...

Ray Alcorn is CEO and a principal of **Park Real Estate Inc.,** a commercial real estate development and investment firm based in Blacksburg, Virginia. The company owns and manages a portfolio of retail, office, and hospitality properties.

Ray has been in the commercial real estate industry for over 30 years. He hosts the Commercial Real Estate Discussion Forum at **CREOnline.com**, where he answers questions and participates in discussions with investors from across the US and the world.

In his home study course, **DealMaker's Guide to Commercial Real Estate** he shares a lifetime of experience investing in commercial real estate. This book provides real-world information written by a true dealmaker, including how to design your personal investment criteria to fit your overall life goals. It is an invaluable resource for creating and building wealth in commercial properties of all types.

DEALMAKER'S GUIDE

Strategic Intelligence for Commercial Real Estate Investors

2012–2013 Commercial Real Estate Forecast:

Opportunity is Knocking

By Ray Alcorn

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"*The ladder of success is best climbed by stepping on the rungs of opportunity.*" - Ayn Rand

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Friends & Colleagues:

Before getting into this year's forecast I want to thank the many people who have contacted me through my new website at **DealMakersGuide.com**. It's been good to reconnect with a lot of old friends and add new ones as traffic grows. If you have friends who would enjoy the content please take a moment and forward the link.

On the site you'll find my blog, **Dirt Merchant Digest**. My goal is to use the blog to post thoughts on current events, and give you a look over my shoulder at my personal investment strategies. Please post comments to the posts that most interest you. And let me know what's on your worry list, the things that keep you awake at night. Those are the topics I want to write about to help us all make better investment decisions.

And while we're talking about connecting with each other, you can also find me on the following social media sites:

Facebook at https://www.facebook.com/ray.alcorn

Dealmaker's Guide on **Facebook** at https://www.facebook.com/DealMakersGuide

LinkedIn at http://www.linkedin.com/in/rayalcorn

Google + at Ray Alcorn

Please send me a friend or connection request and I will immediately accept it. (By the way: I also have a Twitter account, **@ray_alcorn**. Several friends (?) have brow-beat me into tweeting. So far I've tweeted maybe a dozen times. Not sure why, but there, I did it.)

And for 12 years and counting I am still hosting the **CREOnline Commercial Real Estate Forum**. The site was revamped last fall and if you haven't checked it out you should. The new forums have much better functionality, including user profiles, private messaging and personal archives. I invite you to join the discussion.

Enjoy my outlook for an exciting period in real estate, **"Opportunity is Knocking".**

Uncertainty on a Grand Scale

For those who were around in the early eighties the current times have a familiar tone—a sense of foreboding that comes with the uncertainty of *not knowing* what lies around the corner in business, politics or world affairs.

Uncertainty was a secondary factor in last year's outlook, overshadowed by the more immediate headwinds of housing, unemployment and stagnant income growth threatening the nascent recovery from the Great Recession. However by mid-year I tempered my pessimistic outlook, and actually feel good about the prospects that my call for negative GDP growth would be wrong (and it was, though 1.7% growth is hard to get excited about).

On a personal level our company experienced an increase in leasing activity in our office buildings and retail properties. Our banks were eager to make loans—though on decidedly more conservative terms—and we closed funding for two construction & improvement projects. Things were looking up.

But I underestimated the ability of politicians to do exactly the wrong thing. Starting in late summer, Congress and the White House engaged in a cage match worthy of the WWE over the debt ceiling. Then came a first-ever ratings downgrade of US Treasuries, which spurred a contradictory rally in Treasuries, bringing interest rates to historic lows. Not to be dissuaded from making things worse, the politicians closed the year with a *two-month* deal to extend a 2% payroll tax break (extended for one year in January), and the Fed announced their zero-percent interest policy will remain in force for three years, through late 2014, telegraphing their expectation of slow growth for the foreseeable future.

This had a marked effect on the capital markets and in real estate. The year started with a huge increase in transaction volume, but every report in the second half was of slowing activity. In most situations, a confused mind says "no".

Playing Kick the Can in a Cul-de-sac

If the number of decisions being deferred by our leaders doesn't make you nervous, you're not paying attention. The inability of Congress and the Obama administration to make any substantive progress is beyond the scope of how I previously defined gridlock.

Given the current state of affairs, here's what we know *won't* happen in 2012: Congress won't pass a budget, or cut spending, or do anything that might play badly in the media during the election cycle. In fact if the economy slows down in the latter half of the year I expect to hear a lot of noise about additional market-distorting stimulus programs. (QE3 anyone?)

In the past I have considered gridlock a good thing. Gridlock creates a type of certainty which supports the axiom, "If nothing changes, nothing changes". It certainly makes forecasting a lot easier. But the current brand of gridlock could prove to be disastrous. The list of "kicked cans" (see chart on next page) is enough work for two congressional terms, and they all hit at once in January 2013. This is uncertainty on a grand scale, and the fact that it's an election year insures nothing will be done to address the real problems until they have to.

Policies set to expire or take effect under current law	Fiscal Drag (% of 2013 PGDP)
Sequester Automatic Cuts (Discretionary Spending)	-0.40%
Sequester Automatic Cuts (Mandatory Spending)	-0.10%
Bush Tax Cuts ($250k+ Incomes, Estate Tax)	-0.30%
Bush Tax Cuts (Middle Income)	-0.90%
Alternative Minimum Tax	-0.80%
Payroll Tax Cut	-0.60%
Emergency Unemployment Compensation	-0.20%
Affordable Care Act	-0.20%
Total Fiscal Drag	**-3.50%**
Source: JP MorganChase; EOTM 4/9/12	

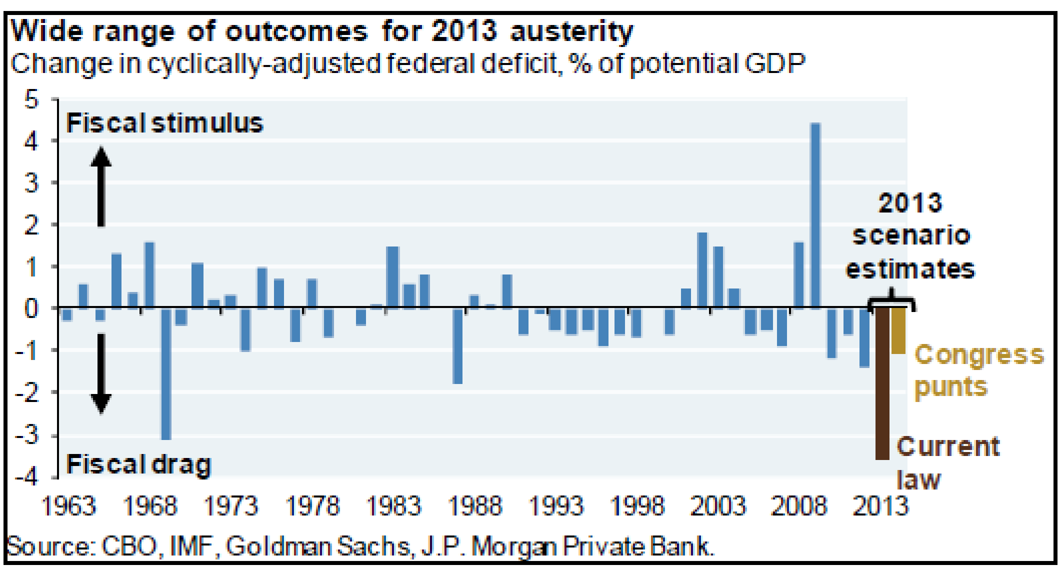
The chart at left lists the deferred decisions that will be on the agenda of the Department of Can-Kicking, I mean Congress, in January 2013. ("Sequestration" is the term used for the mandatory cuts agreed to by the Debt Reduction Committee formed to resolve the debt ceiling "crisis last summer.)

Analysts at JP Morgan estimated the fiscal drag of all the provisions scheduled to expire and kick in during 2013 if Congress does nothing. The estimated total drag on potential GDP growth is about 3.5%. To put that in perspective, total growth for all of 2011 was 1.7%. Please note this is regardless of the election outcome.

Add to the list the likely need for another increase in debt ceiling. Prepare to be amused.

But if Congress and the President elect to extend current tax rates, retain lower payroll tax rates and extended jobless benefits, the adjustment would not be as big.

The following graph only reflects expiration of Recovery Act provisions, the recently passed Budget Control Act, and some other smaller provisions. There are of course plenty of permutations in between. Bet on more can-kicking wherever possible.



An interesting report about the K-Street lobbying firms in Washington indicates 2011 was a down year (10% to 25% decrease in revenue), and they don't expect 2012 to be any better until the election is over.

> Several lobbyists predicted 2012 would be another slow year. Lawmakers are distracted by election-year politics, and legislation is unlikely to move after the first few months of the year. Rich Gold of Holland & Knight said things could speed up in the second half of 2012, especially after campaign season comes to a close.
>
> "You will have the holy trinity of lame-ducks, which is sequestration, the Bush tax cuts and the debt limit. It doesn't get much better than that," Gold said. —The Hill, *On K Street, 2011 was Year to Forget,* 1/20/12

The article above goes on to say that while legislative lobbying may be in a slump, revenues are rising to influence regulatory actions. Given the legions (139 at last count) of boards and commissions currently writing thousands of rules to implement the Dodd-Frank financial reform bill and the Affordable Health Care Act, there are ample opportunities for industries with vested interests to influence the outcome in their favor.

Macro-economic Forecasts

Lest we be fooled, inaction in Washington does not mean we're safe at home. Of the three-dozen or so financial and economic sources I subscribe to the opinions are split about as to whether we will fall back into recession. The following chart lists forecasts from well-known sources to illustrate the point:

Source	GDP	CPI	Unemployment	10-year Treasury	Recession Yes / No
A. Gary Shilling	-0.8%	0.7%	9.8%	1.5%-2%	Yes
Goldman Sachs	1.5%	2.2%	N/A	N/A	No
Federal Reserve	2.2%-2.7%	2%	8.3%	N/A	No
Kiplinger	2.3%	2%	8.3%	2%	No
Casey Research	-1%	3.7%	9%	2.7%-4%	Yes
Mortgage Bankers Assoc.	1.8%	2.0%	8.5%	2.3%	No
John Mauldin	2%				60/40 No
JP Morgan	<2%	3%	8.5%	2%	No
Financial Forecast Center	-0.1%	3.4%	8.8%	3.3%	Yes

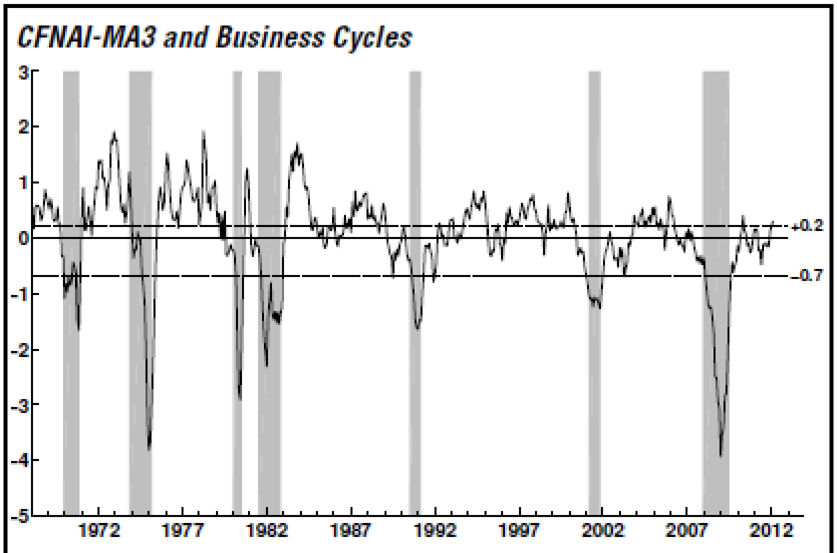
Each of the forecasters makes a good case for their position. The conclusion I draw is that the best case scenario is "below trend" growth (defined as <2%), and worst case a mild recession.

However, it's worth noting that a controversial recession call came out of the blue from ECRI (Economic Cycle Research Institute). On September 30th 2011 ECRI publicly announced that the U.S. is tipping into a recession, a call the Institute had announced to its private clients on September 21st. Here is an excerpt from the announcement:

> "Early last week, ECRI notified clients that the U.S. economy is indeed tipping into a new recession. And there's nothing that policy makers can do to head it off. [...] In fact, the most reliable forward-looking indicators are now collectively behaving as they did on the cusp of full-blown recessions, not "soft landings."
>
> [...] It's important to understand that recession doesn't mean a bad economy – we've had that for years now. It means an economy that keeps worsening, because it's locked into a vicious cycle. It means that the jobless rate, already above 9%, will go much higher, and the federal budget deficit, already above a trillion dollars, will soar."

Here's what ECRI's recession call really says: if you think this is a bad economy, you haven't seen anything yet. And that has profound implications for both Main Street and Wall Street.

The next chart is from the best economic forecasting tool you've never heard of, the **Chicago Fed National Activity Index.**



Notes: Shading indicates official periods of recession as identified by the National Bureau of Economic Research. A CFNAI-MA3 value below –0.70 following a period of economic expansion indicates an increasing likelihood that a recession has begun. A CFNAI-MA3 value above –0.70 following a period of economic contraction indicates an increasing likelihood that a recession has ended. A CFNAI-MA3 value above +0.20 following a period of economic contraction indicates a significant likelihood that a recession has ended.

The CF-NAI has a sterling track record of accuracy in predicting recessions 6–12 months out: 96.2% correct, with 0 false positives over the last seven recession cycles. The March 2012 report above included the following comment:

> The index's three-month moving average, CFNAI-MA3, increased from +0.22 in January to +0.30 in February—its highest level since May 2010. February's CFNAI-MA3 suggests that growth in national economic activity was above its historical trend. The economic growth reflected in this level of the CFNAI-MA3 suggests limited inflationary pressure from economic activity over the coming year.

As you can see on the graph, the last three months broke a downward trend from the March 2011 high. This is confirmation of the mixed forecasts, with leading, coincident and lagging indicators all tightly grouped around a low-growth scenario. This will play into our strategic decision-making for real estate portfolio management in Part 2.

I'll close this section with my own calls for the above categories. Not that anyone cares, but after hundreds of hours of research I do have an opinion, and I might as well put it out there. Herewith are my predictions for year-end 2012 economic activity:

Source	GDP	CPI	Unemployment	10-year Treasury	Recession Yes / No
Ray's Best Guess	1.5%-2%	2.5% x-food & energy 4.5% overall	8.5%-9%	2%-2.5% range	Not this year, 2013 = 50/50

For me this is not an idle exercise. It's much easier to work with the trends than against them. We use this research in our firm to prepare annual operating budgets and a work plan. Price levels and the cost of capital are critical for an accurate estimate of revenues and expenses is essential to forecasting our operating cash flow. Overall economic growth or contraction (including local conditions) gives insight to the feasibility of acquisitions, sales, development and financing.

Demographic Trends: Housing, Employment & Income

I am going to spend an inordinate amount of time on housing for one reason; it dominates the landscape in its effects on the economy as a whole.

Typically housing is a lagging indicator. In a normal business cycle autos are the traditional canaries in the coal mine of a pending downturn, and housing sales don't decline until well into a downturn. Conversely, auto sales will turn up early in recovery, while housing has a 9-12 month lag time after an upturn begins.

But the Great Recession was all about housing and the related capital crisis. The impact of the bursting of the housing bubble includes a cumulative 40% decline in housing prices (so far); a 75% reduction in construction and related sector jobs; and the negative effects on the capital markets from nationalization of 90% of the residential mortgage industry. The impacts have been and remain so severe and widespread that the health of the national housing sector has a disproportionate effect at the local market level.

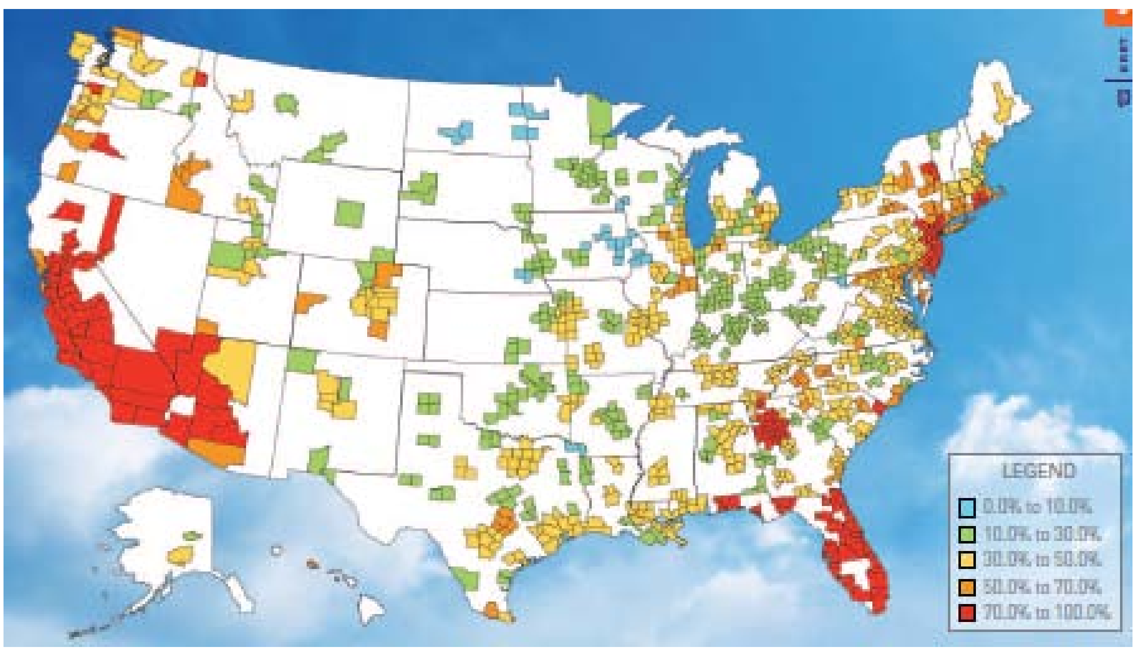
My belief is that we will not return to normal growth trends without a recovery in housing. Almost no sector of the country or type of real estate can be considered in isolation of the local market dynamics of housing. We'll start with the hot button issue of the day, foreclosures.

Foreclosure Trends

Foreclosures should have peaked last year, but volume was pushed forward to 2012 due to the robo-signing flap and MERS title issues. Now that the government's $25 billion extortion of the big banks is settled, foreclosure activity will explode in 2012, adding another 1 million homes to the existing oversupply of 2 million units.

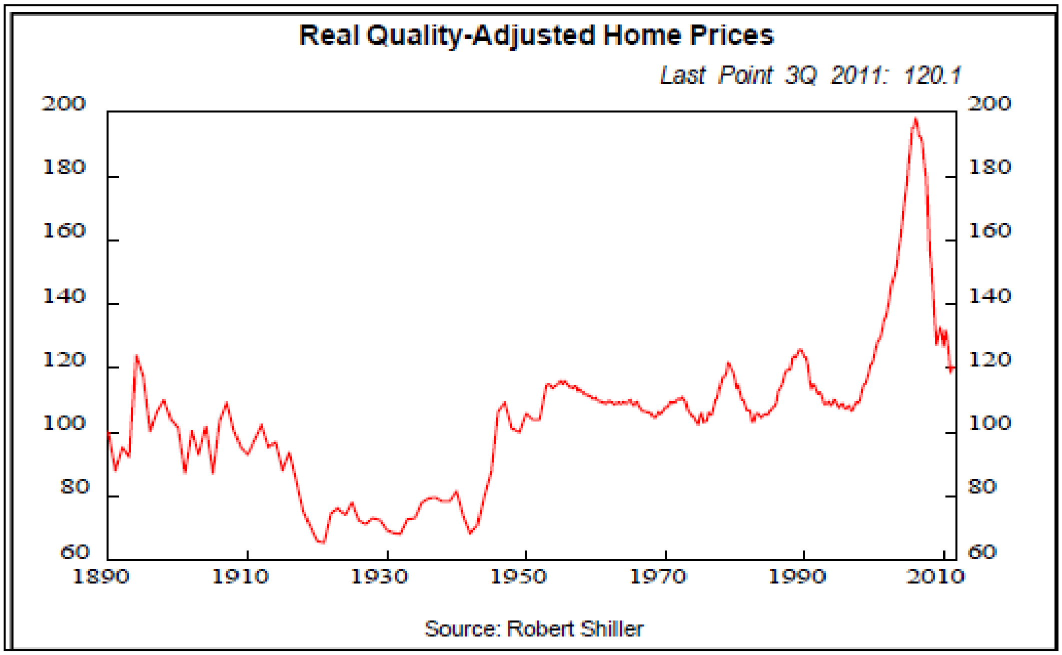
The **[Q3 2011 report]** from PMI Mortgage Insurance Co. (PMI) on the risk of decline in house prices reflects the troubled areas. The following graphic depicts very few blue spots—the color used for a 0%-10% minimal risk factor—but a lot of green (10%-30%, low risk) and yellow (30%-50%, moderate risk), and significant areas of red (>70%, high risk). (See the report for details of the 384 MSA's.)

This is encouraging, as house prices are indicative of overall market health for all real estate types. Many commercial investors (including me) use the PMI risk ratings as part of their market due diligence. For decades PMI issued mortgage insurance for the portion of loans exceeding 80% LTV. This put them a first loss position for underwater mortgage foreclosures, and provides an extremely accurate read of where the most severe problems exist.



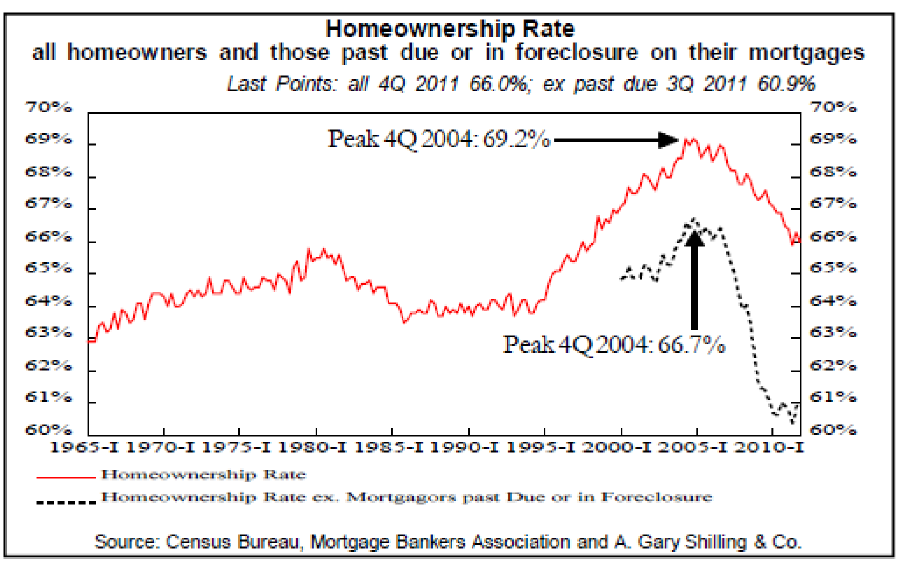
As can be seen, prices in Midwest and Sunbelt markets are stabilizing, mostly those around employment centers, ports and inland metros (supply is not, see below). The hardest hit, CA, NV, AZ, and FL are still at risk. (It is ironic, but telling, that PMI ceased issuing new commitments for insurance coverage as of August 19, 2011, and is currently under the full and exclusive possession and control of the Arizona Department of Insurance.)

The Dallas Federal Reserve Bank states that a [further] 23% decline is needed to return house prices to their long-run trend. Prof. Robert Shiller of Yale, who compiled the long-run house price data in the next chart, says there is a "substantial risk" of another 15% to 20% decline in house prices. (Source: Gary Shilling's Insight, Feb., 2012)



Data through December 2011, released 2/28/2012 by S&P Indices for its S&P/Case-Shiller Home Price Indices, showed that all three headline composites ended 2011 at new index lows. The national composite fell by 3.8% during the fourth quarter of 2011 and was down 4.0% versus the fourth quarter of 2010.

However, despite the efforts by the government and the courts to keep homeowners in their houses, homeownership is falling. In the fourth quarter of 2011, it fell to 66.0%, down from the 69.2% peak in the fourth quarter of 2004. The following chart reflects the continued decrease in the percentage of home ownership. (Source: A. Gary Shilling)



Please note in this chart a salient point I have not seen mentioned by any other analyst. Deducting delinquent mortgages and pending foreclosures from the ownership numbers, the *net* ownership percentage falls to 61%. At the current rate of decrease, this may indicate the bottom by 2016. How long it will stay that low is anyone's guess. I would not think there will be any increase as long as a house is a depreciating asset.

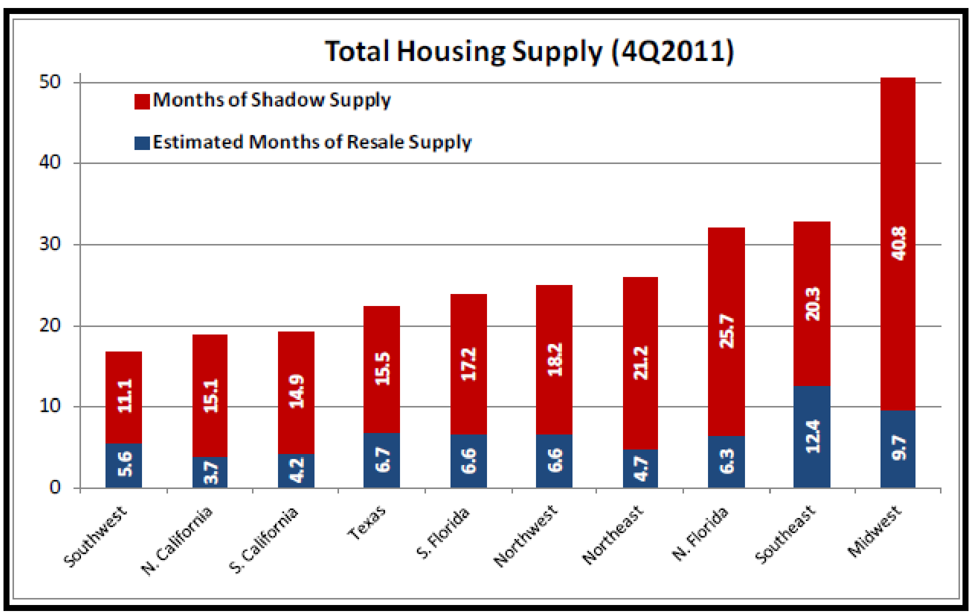
U.S. Housing Supply Source: Census Bureau 4Q 2011	
All housing units	132,474
Vacant	18,389
Year-round vacant	13,876
For rent	4,058
For sale only	1,782
Rented or sold	913
Held off market	7,122
Occas. use	2,187
Usual residence elsewhere	1,329
Other	3,606
Seasonal	4,512
Total occupied	114,086
Owner	75,315
Renter	38,771

The table at left depicts the breakdown of the US housing stock. Note the line item for "Vacant – Other" of 3.6 million units. This is where foreclosed houses not yet listed for sale and vacant units pulled off market are accounted for in the census data.

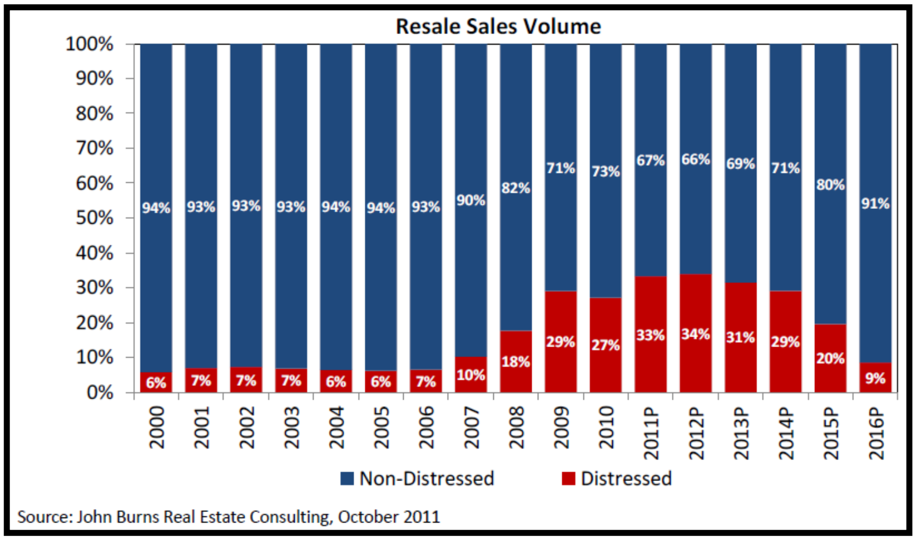
This category has increased from 2.6 million since 2006. The reported numbers of home inventory do not include this segment, nor do they include delinquent mortgages headed for foreclosure.

Franni (FreddieMac & FannieMae) reported 226,000 REOs in September 2011, about half of the reported total of 550,000 REO's on the books of all institutions (Q2 2011). As of December 2011 FHA reported 711,082 "seriously delinquent" FHA-insured single-family loans likely headed for foreclosure. Total 90+ day delinquencies are over 1.5 million loans, which includes an undetermined number of stalled foreclosures from last year. CoreLogic (see below) estimated in December 2011 that the current residential shadow inventory as of October 2011 remained at 1.6 million units.

For a graphic look at the amount and geographic location of the oversupply, the following chart is from [John Burns Real Estate Consulting]() (JBREC):



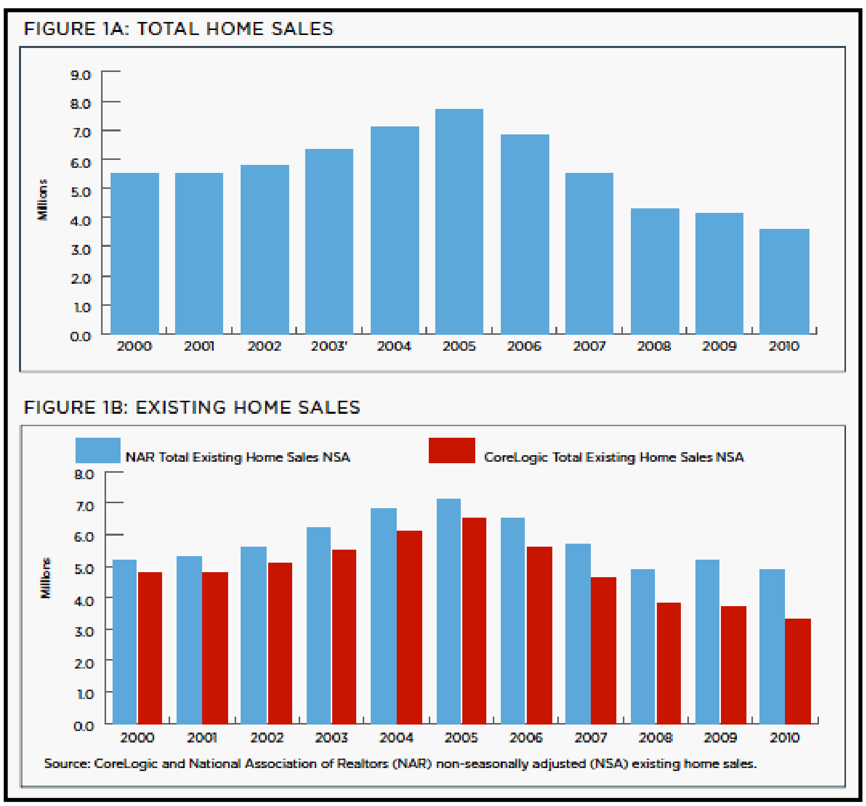
Further, the volume of distress sales is projected to peak this year.



Source: John Burns Real Estate Consulting, October 2011

Given this data, reports from the National Association of Realtors (NAR) of falling supply are significantly understated.

This brings up a pet peeve. Pardon me for a moment while I rant. The media quotes the sales and inventory numbers from the NAR as the gospel of housing activity. These numbers have been suspect by professionals in the industry for years. Now there is confirmation that the NAR has inflated sales numbers and deflated supply. The following chart compares the reported sales over the past decade by NAR as compared to data collected by **CoreLogic**, a California firm which collects property transfer data from 85% of the courthouses in the country.



Source: CoreLogic and National Association of Realtors (NAR) non-seasonally adjusted (NSA) existing home sales.

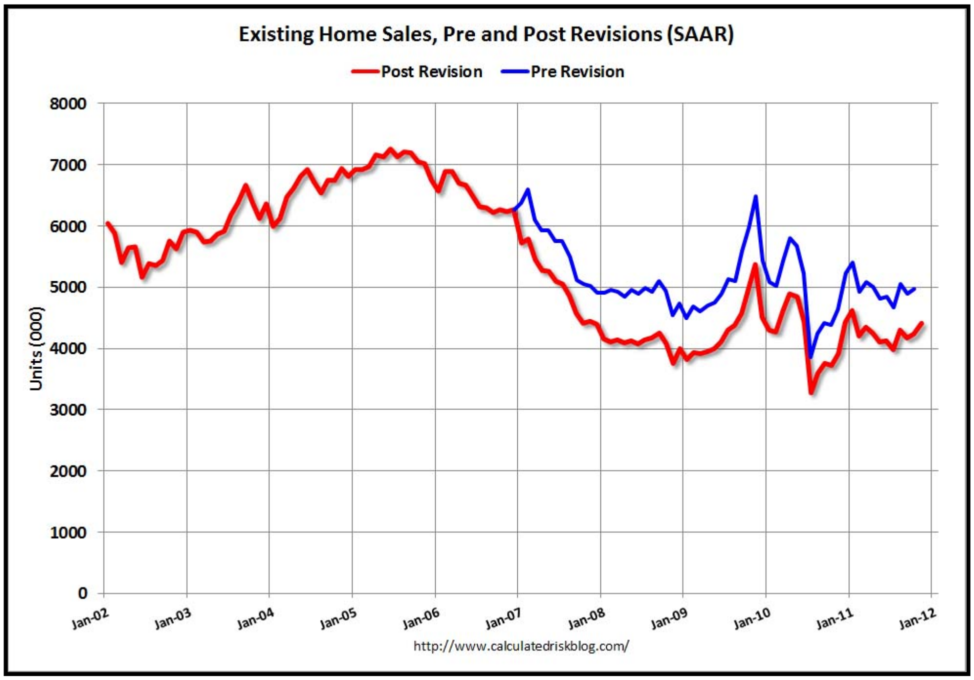
CoreLogic reported in their US Housing and Mortgage Trends - February 2011 :

"Although it's been widely reported that the National Association of Realtors' (NAR) existing home sales data fell only 5% to 4.9 million in 2010, down from 5.2 million in 2009 and flat relative to 2008, the CoreLogic data indicates otherwise."

Historically, the CoreLogic existing sales data have covered about 85% to 90% of all NAR's existing home sales data. However, in 2006 NAR's sales data became elevated relative to the CoreLogic, MBA, HMDA and Census sales related data, and that trend has continued and become more pronounced through 2010. There are several reasons for the divergence, including benchmarking drift, more sales going through MLS systems due to consolidation and a lower share of for sale by owners (FSBO) home sales. Net, **NAR's existing home sales data are overstated by about 15% to 20%**.

In December 2011 the NAR finally capitulated and made benchmark revisions to historic existing home sales data. From NAR:

> "The 2010 benchmark shows there were 4,190,000 existing-home sales last year, a 14.6 percent revision from the previously projected 4,908,000 sales. *For the total period of 2007 through 2010, sales and inventory were downwardly revised by 14.3 percent." [Emphasis mine]*



In February 2012 the NAR reported "existing home sales increased 4.3 percent to a seasonally adjusted annual rate of 4.57 million in January from a downwardly revised 4.38 million-unit pace in December."

CoreLogic reported 2011 total sales of 3,804,000, still over 10% below the revised NAR number. Further, the NAR still did not attempt to produce an actual count, instead tweaking their model to show a flat reduction across the board. Statistically that's allowable if one doesn't have to make real-world decisions based on the data. But in the midst of the worst housing crisis in our history it seems to me neatness would count.

	2009	2010	YTD 2011
Total Sales*	4,253	4,010	3,804
-New Sales*	387	328	268
-Existing Sales*	2,697	2,579	2,455
-REO Sales*	887	789	749
-Short Sales *	235	273	307

Source: ***CoreLogic**- February 2012 Market Pulse*

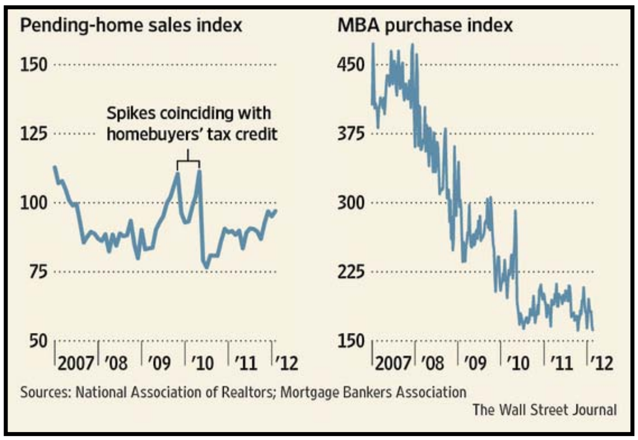
Compare the revised NAR numbers in the graph above with this chart at left.

It is readily apparent that in addition to overstating sales in 2011 by over 1,100,000 units, the NAR "errors" completely obscured the real trend of declining sales numbers in every category except short sales! It is beyond belief that the NAR has any remaining credibility.

I'm not alone in my scorn for bogus data. Joan McCollough, VP of Macro Strategy with **East Shore Partners**, an independent research and brokerage firm, had this to say about the January release:

> **"January Existing Home Sales.** Expect[-ation] 4.65 mil. Actual: 4.57 mil. Even though the number of units fell far short, the m/m percentage change shows January bangin' in with a 4.3% increase. This means that they must have given December one heck of a revision. Lemme check. Hot diggity dawg, these guys have big ones. Look: December originally posted 4.61 mil which was +5%. They have revised that DOWN to 4.38 mil. They revise numbers back 3 years each February, yet I cannot account for a single-month with a 5% dip. This is atrocious after that huge revision they did a couple o' months back. I wonder why we even give these jokers any ink."

Now the NAR is trying a new trick, a Housing Sales Index, but again the data is misleading. (Source: Wall Street Journal; February 28, 2012, *Sales Index Spurs Hope For Housing*)



This time the **Mortgage Bankers Association Purchase Index** provides the counter-factual. Over the same period that NAR touts a 20% increase in pending sales, MBA reports a 9.1% decline in Purchase Mortgage apps for the same period.

When I see the NAR numbers posted each month I automatically go the **CoreLogic** and ***JBREC*** websites to get the real story. If you are a member of NAR, do us a favor and tell your leadership that the association is the laughing-stock of the industry due to sloppy data, and sell-side promotion that would be called "pump-and-dump" in the stock exchanges. Okay, rant over. Thank you for your indulgence.

Obviously (to all but the NAR), an additional 1 million units of supply in the face of declining sales is a sure recipe for further price erosion. As a result the ownership percentage will most likely over-shoot to the downside due to the still increasing supply as well as the headwinds of stagnant wage growth, high unemployment, tight lending standards and higher down payments, and the long-term effect of credit problems created by foreclosures, short sales, and delinquencies.

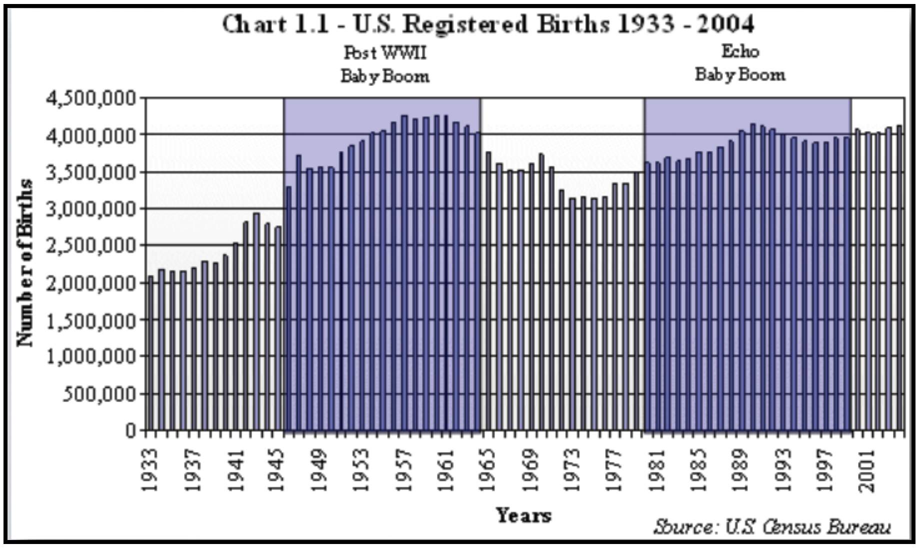
This brings us to the silver lining for real estate investors. Every 1% decline in the home ownership rate creates approximately 1.1 million *potential* renter households (some will be combined).

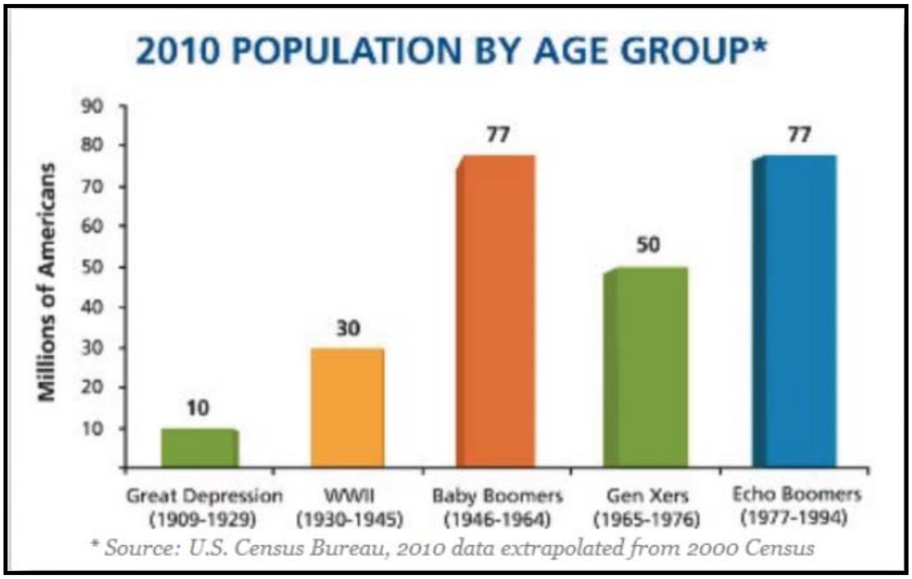
The rate of decline has been about 1% per year since 2008. Assuming the trend continues at that rate indicates a 4% decline in ownership to 62% by 2016 when supply and demand are expected to stabilize, creates 4.4 million additional renter households. Regardless of how you slice the data, that's a significant jump in demand for rental housing.

Generational Double Whammy

The increased demand for rental housing is not a short-term phenomenon. The two primary rental household age cohorts are 18-35 and 55+. The former are those entering the work force or college, college graduates and young married couples. The latter is comprised of empty-nesters and retirees.

The following charts from [37th Parallel Properties] illustrate the trend that will be in force over the next two decades.





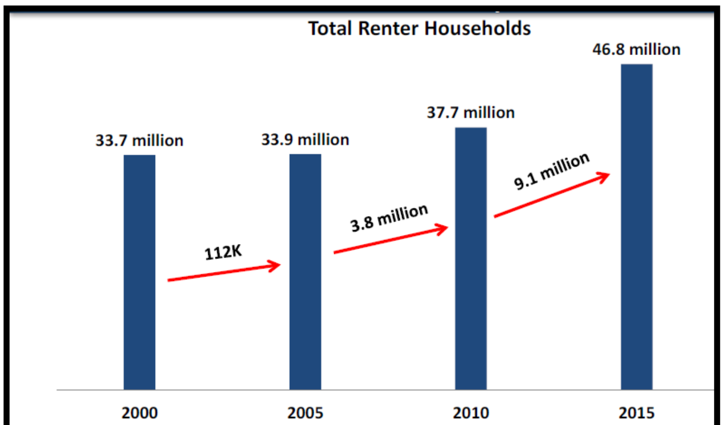
Charts courtesy of 37th Parallel Properties

As you can see, each of these age groups is outsized in number when compared to long-trend birth and population data. Each group has a unique set of factors to consider in the decision of whether to own or rent a home.

Echo-boomers express significantly less interest in owning a home than past generations, driven by two macro-trends: First, this generation has the shortest length of employment in one job than preceding generations, averaging a job change every three years. Owning a house in a slow market is a financial deadweight which significantly reduces mobility. Second, there is little attraction to investing in a depreciating asset. Building wealth through home ownership is no longer a “safe” option.

Empty-nesters and retiring baby-boomers face even more difficult circumstances. As they seek to downsize they are whipsawed by prices that have fallen over 40% in the past three years—especially in the upper price range—and the increasing costs of property taxes, insurance and maintenance. The lack of demand by first-time buyers prevents the move-up buyer, who traditionally purchased the bigger homes of retirees, from being able to purchase. Boomers are left with a Hobson’s choice: sell their house at current prices, or stay put and gradually lose disposable income as expenses rise. Older boomers are now retiring at the rate of 10,000 per day, and will be for the next twenty years. In addition to the increased costs of home ownership, retirees face rising health-care costs and insurance premiums.

Chad Doty, CEO and co-founder of 37th Parallel Properties has been watching this trend unfold for several years, and built the business model of his company around it. He observes, “Since 2005, an average of 804,000 new rental households per year have been created, compared to just 75,000 per year from 1990-2004. That’s a 1040% annual increase in rental households, and just a stunning change. The historic ratio of 65/35 home ownership to rental households has inverted, to 25/75.” We will hear more about his business model in Part 2.



Source: John Burns Real Estate Consulting, Apartment Analysis & Forecast, January 2012

This trend is supported by data from every source I have.

John Burns Real Estate Consulting projects an increase of renter households of 9.1 million over the five years beginning in 2010 (chart at left).

Now let’s consider the supply side of rental housing.

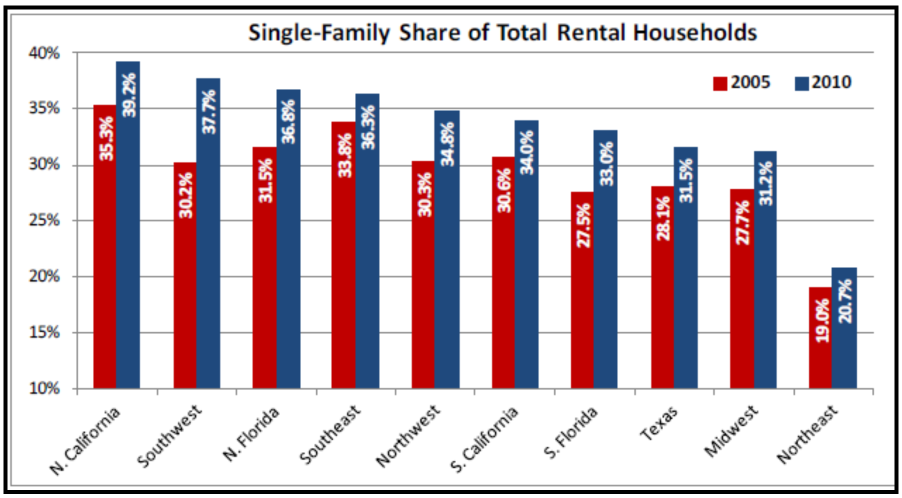
Housing Supply

2011 multi-family completions were just over 100,000 units (Reis), a historic low. The projection for 2012 completions is 172,000-185,000 units. This is well below typical production levels. The mean for production of multi-family housing units since 1990 is 239,000 units per year. If you believe in reversion to the mean (which I do), it is apparent that construction is lagging demand. The pace of new construction is constrained by stringent lending requirements, which we will discuss in a moment.

I believe 2012 multi-family starts will exceed 200,000. If so, and the rate of increase continues, then 2014 will be the year for completion equal the long-term trend. But reversion to the mean typically involves over-shoot. Production will likely exceed the mean for several years before the cycle returns to a normal trend line. As we've just seen, new construction is unlikely to meet demand for several years. This bodes well for continued strength in multi-family performance fundamentals for an extended time.

Rental Houses: the known unknown in rental supply

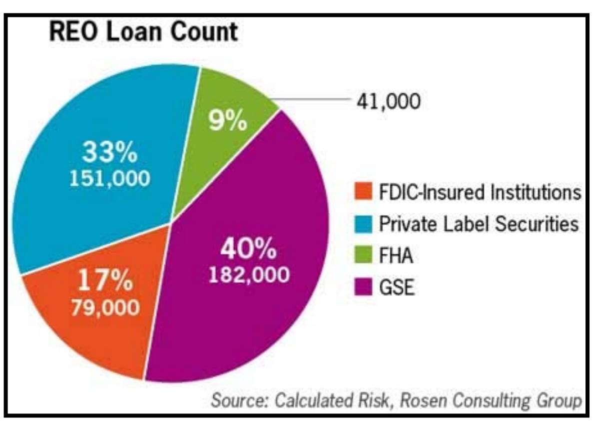
The unknown is how much of the rental demand will be met by vacant single-family houses (SFR). **Real estate investors at every level are the key to clearing the market of oversupply**. The trend is underway and as supply becomes available it will gather steam. There are signs that 2012 will be the year that financial institutions are finally able to digest low asset valuations and liquidate REO inventories and non-performing in bulk sales, which will likely result in more of the existing SFR inventory to be converted to rental housing.



Source: John Burns Real Estate Consulting

The FDIC is now selling REOs in bulk to investors. Fannie upped the number of allowed investor (non-owner occupied) mortgages from 4 to 10, with the caveat that the properties cannot be sold for four months post-closing, ostensibly to prevent flipping at the closing table. Heaven forbid someone make a profit from their poor lending policies.

On Feb. 27, 2012 the Federal Housing Finance Agency (FHFA), the regulator for all federal government housing agencies, announced a pilot transaction under the Real Estate-Owned (REO) Initiative. The first pool of assets is a group of 2,490 properties, including 2,849 units in some of the hardest-hit residential markets: Atlanta, Chicago, Florida, Las Vegas, Los Angeles and Phoenix. There are 1,743 single-family homes, 527 condos, seven manufactured homes, one co-op, 118 duplexes, 36 three-unit buildings and 58 four-unit buildings.



According to the press release, "Pre-qualified investors will be able to submit applications to demonstrate their financial capacity, experience and specific plans for purchasing pools of Fannie Mae foreclosed properties with the requirement to rent the purchased properties for a specified number of years. Investors must fill out a qualifying form on the FHFA's REO Asset Disposition page, post a security deposit and sign a confidentiality agreement to access detailed information about the properties."

This is a major turning point to clear the market of distressed properties. Finally the window of opportunity has opened to bulk sales to parties other than hedge funds and private equity groups. Until now only funds with large amounts of capital have been allowed to participate in the FDIC's PPIP program to liquidate loan portfolios from closed banks. This is a welcome change. Bulk portfolios of REO's, performing and non-performing loans, and MBS holdings will be available to direct investors throughout 2012-2013.

Multi-family Bubble?

Recently I've seen several screeds online proclaiming sure knowledge that "dumb money" is back, and fools are rushing in to buy apartment buildings at greater-fool prices. What is it about human nature that compels some to be the first to deliver bad news? I'm reminded of a quote from John Erskine, *"Opinion is that exercise of the human will which helps us to make a decision without information."*

It is true that investor demand for apartment properties has driven valuations back to 2006 levels. Transactions at sub-7% cap rates in major metro markets are common. However a thorough examination of the facts of supply, demand and production leave little room for doubt that the outlook for the rental market at every level is bullish, and will be for some time.

This is good news for real estate investors, and for the economy. In my opinion the only thing that can derail the trend is government interference in the markets, specifically the possibility of guidelines regarding rent controls as conditions of sales, or limits on profits after renovation and resale. In the heightened regulatory climate this is a disturbing, but very real, possibility.

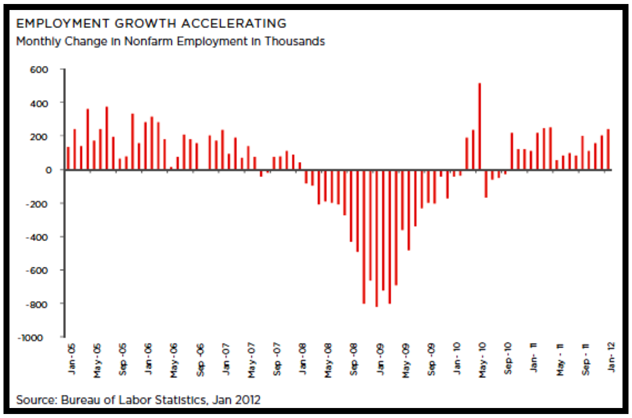
I believe the strong performance for multi-family properties will last longer than past cycles due to the constraints on lending, single-family over-supply and the 12-18 month lag time from permitting to completion for new construction. Development will not catch up with demand for several years. As we will see in the discussion of the capital markets in the next section, stringent loan underwriting standards will slow the construction pipeline for some time.

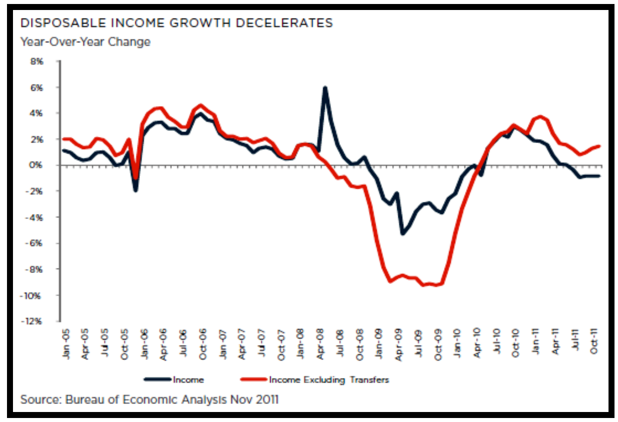
This is not to say there will not be some over-building. The development community has never been a model of restraint. But the demand trend for rental housing has strong legs, and the slower development pipeline will lengthen the cycle for a combination of rent growth and absorption of new units, which are usually mutually exclusive.

Employment and Income

Next up are the perennial factors of employment and household income levels. These factors are critical to all real estate types. Unfortunately conditions have not significantly improved, despite the recent (Feb. 2012) fall in the unemployment rate to 8.3% from 8.9% in March of last year.

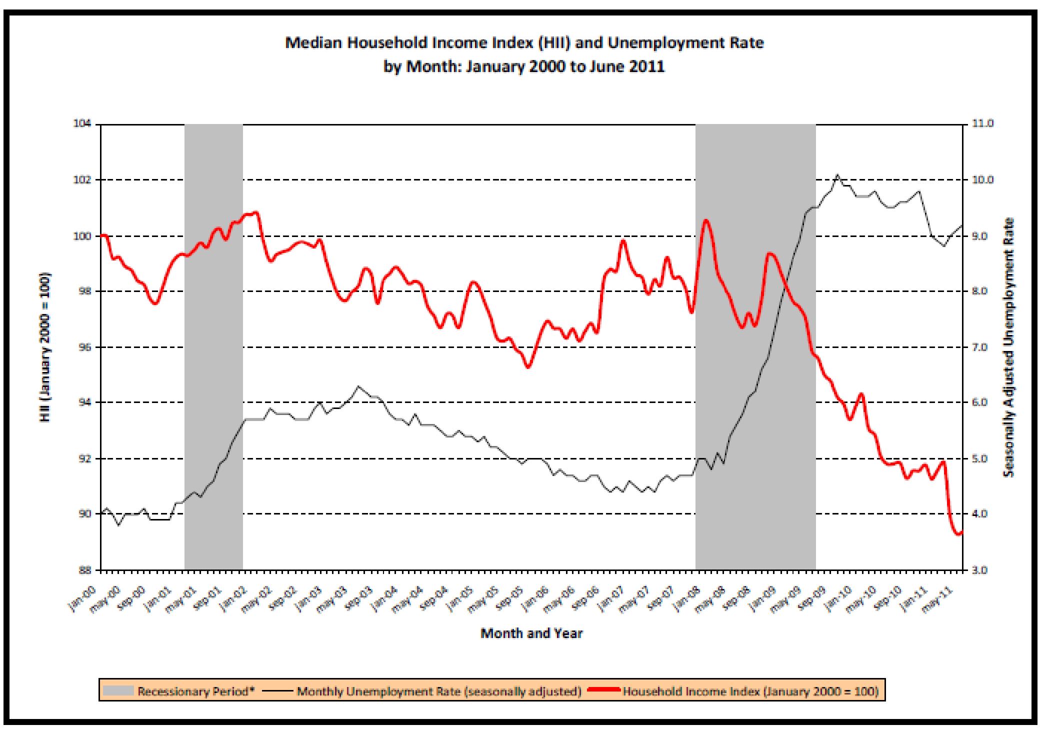
The weakness stems from the fact that real household income is still declining. The following two charts from CoreLogic illustrate the opposing trends:





The falling income trend does much to explain the continued flat perpormance of the retail sector, which we will discuss in Part 2. David Rosenberg of Gluskin Sheff spoke at the Fortigent Winter Forum held in February 2012 in Savannah GA and stated, “While the US may be experiencing a ‘job recovery’, the recovery remains ‘wageless’.”

The problem is now chronic. As shown on the following graph from a report by **Sentier Research**, household income fell more during the recovery than during the recesssion.



Highlights from the report:

- Real median annual household income has fallen significantly more during the economic recovery period from June 2009 to June 2011 than during the recession lasting from December 2007 to June 2009.

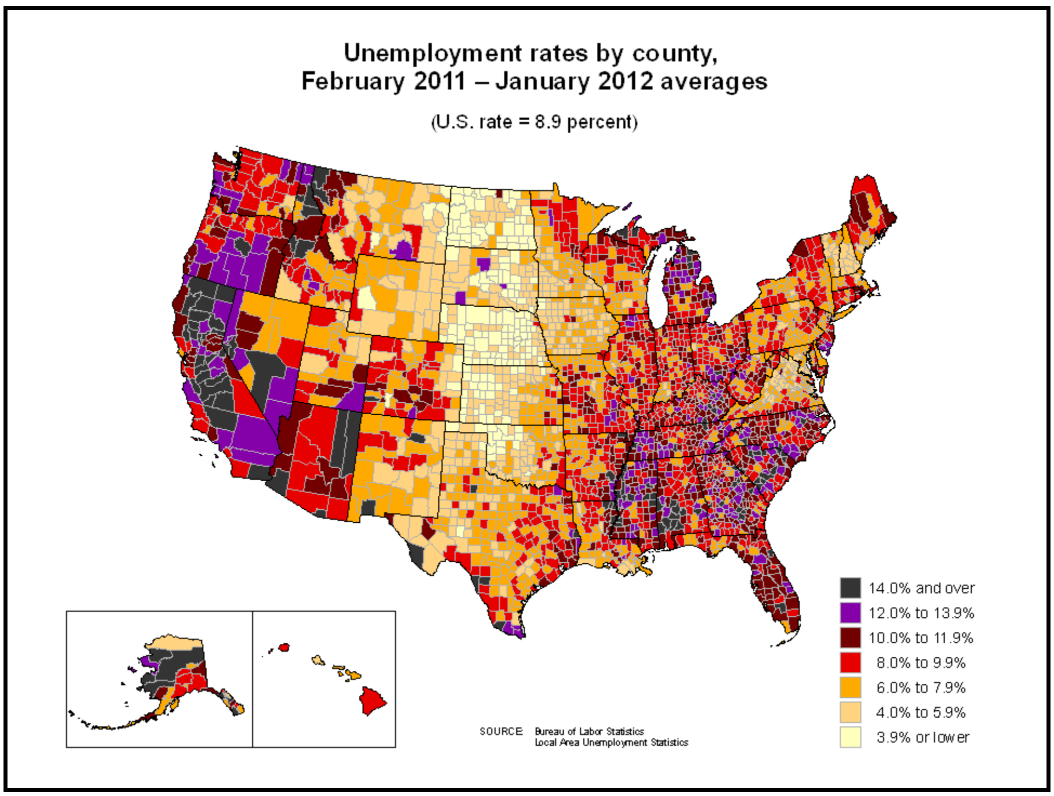
- During the recession, real median annual household income fell by 3.2 percent, from $55,309 in December 2007 to $53,518 in June 2009. During the economic recovery, real median annual household income fell by an additional 6.7 percent, from $53,518 in June 2009 to $49,909 in June 2011.

- For the entire period from December 2007 to June 2011, real median annual household income has declined by 9.8 percent. A decline of this magnitude represents a significant reduction in the American standard of living.

I reach the same conclusion as last year, "that the 'recovery' is frail at best, and likely to be marked with a protracted period of slow growth and a seesaw job market. This is the muddle-through economy, the scenario in which we bounce along the bottom for quite some time."

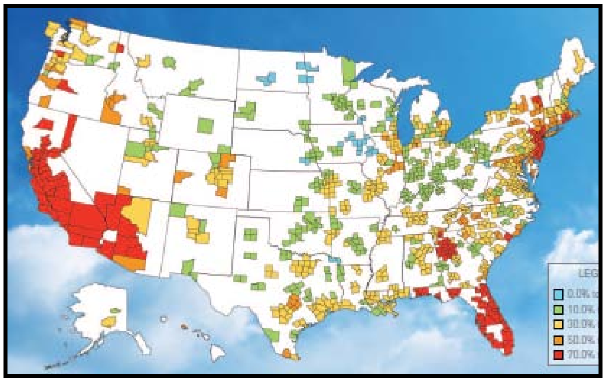
Employment

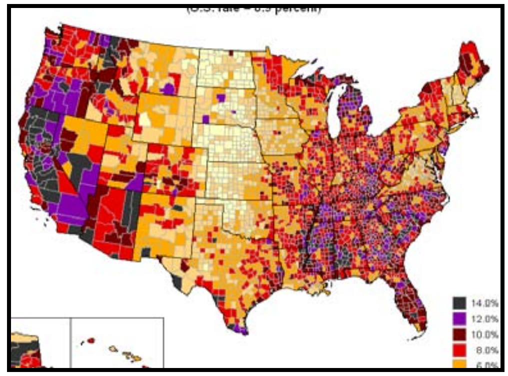
So much has been written about employment, unemployment, underemployment, minority unemployment, teen employment, long-term unemployment and every other subset imaginable that we're all tired of reading about it. Personally I am watching my local employment stats. We're fortunate to be in the low end of the scale, with unemployment between 5.5%-6%.The following chart is from the Bureau of Labor Statistics, and shows the average unemployment rate for every county in the nation.



Source: http://www.bls.gov/lau/tables.htm

The link with the chart will take you to the BLS site where there is enough data to make your eyes bleed. The county data, as well as city, MSA and state data are available in a spreadsheet for each locality. What is most telling is to compare the chart above with the PMI map on page 8. I've put them together to point out the correlation of unemployment and housing.

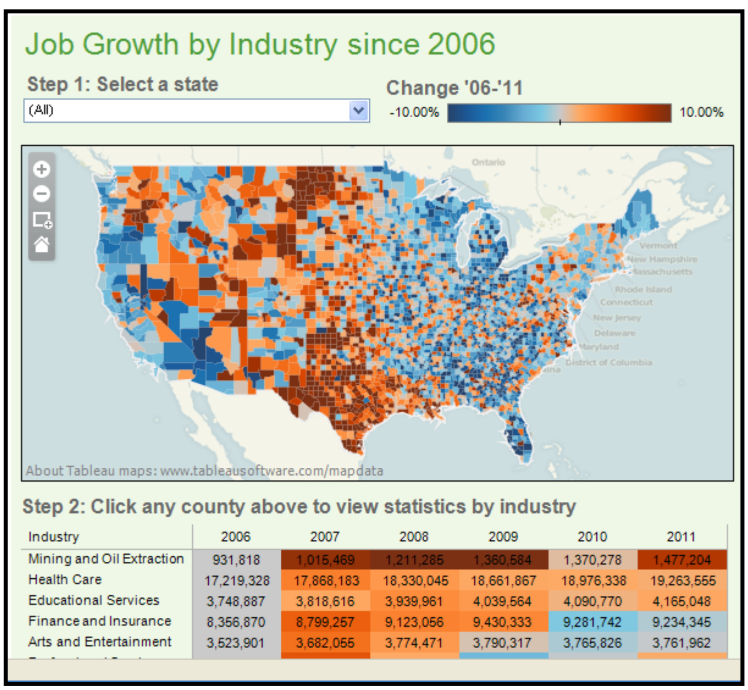




The overlap of employment and housing market risk is apparent. Loss of jobs means higher risk of housing price declines, which means a lower rate of sales, an increase in inventory, which leads to further price declines. It's a self-feeding negative feedback loop, and it will take four to five years to correct the imbalances through natural population growth, attrition and aging.

The ripple effect of housing sales extends into service trades, retail sales, property taxes for local government revenue and the employment levels in the respective sectors. This is another cascade that affects economic health of local markets. To restate my opening point, without recovery in housing there is no sustained recovery.

Just as important as the number of jobs is the type of jobs gained and lost. Here is a very cool interactive map that has a wealth of data for job gain/loss over the last five years.

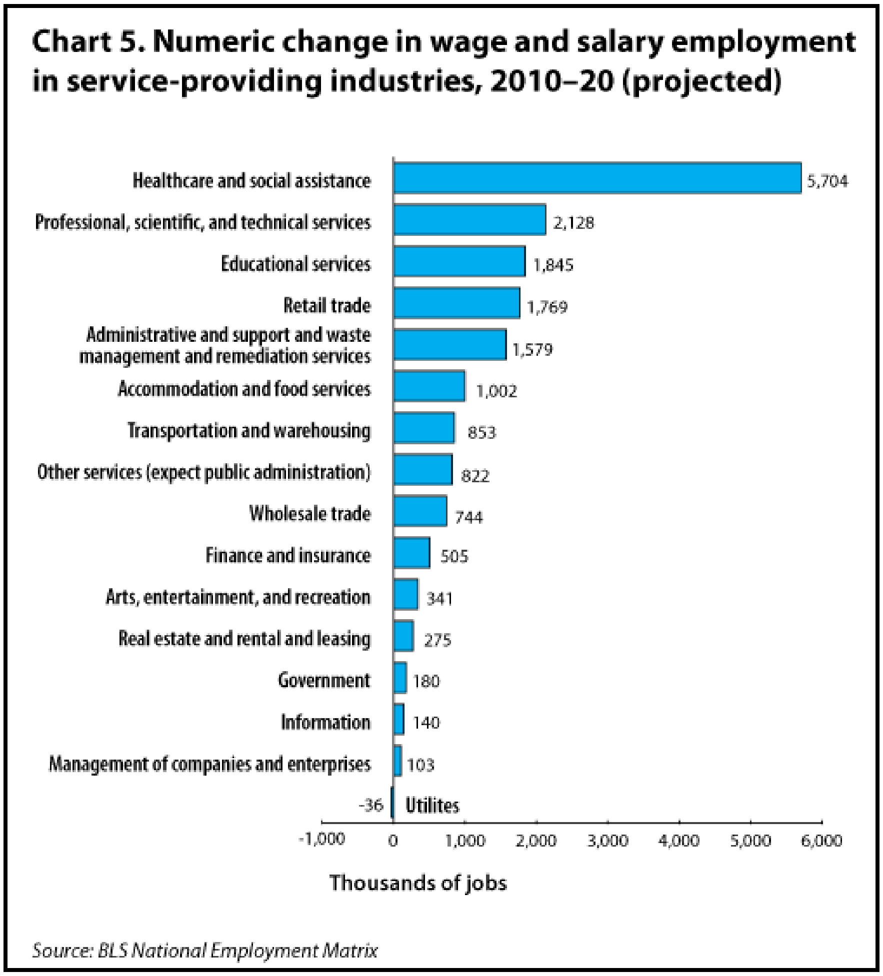


The map is found on the NewGeography website, with this comment.

"The fully interactive map below indicates job growth and decline for all US counties from 2006 to 2011. These show up as hot or cold spots; red for growth, blue for decline. You can select a state to zoom in on and find a county that way, or simply click on a county to drill in. Once you've chosen a county, the table under the map will show you job numbers by industry category. The data for this graphic comes from EMSI's Complete 2011.3 dataset, based on data from the Bureau of Labor Statistics and many other sources. Many thanks to Tableau for putting this together. If you have questions or comments about the graphic or the data behind it, please email EMSI's Josh Stevenson."

The **NewGeography** site also has an index for the [2011 Best Cities for Job Growth](), which ranks 398 US cities, sliced by small, medium and large. I don't have room to insert a list of cities, so consider this an **alert for data geeks**, click on this [link]()!

Just as important as the number of jobs is the type of jobs that are increasing. The next chart is again from BLS, and illustrates the projected growth in each occupational category.



[Source: BLS Occupational Outlook Handbook]()

This is highly usable data. I look at charts like this and think about the *place* those jobs are performed. I mentally count how many of the occupations listed fit into our portfolio of office and retail space. It's a no-brainer to conclude that medical office buildings are going to be in demand to house the 5.7 million new positions in healthcare. Professional services growth bodes well for downtown office buildings. Educational services growth indicates cities and towns with colleges and vocational training will likely grow above trend.

Less obvious is the relatively small increase in government jobs, 180,000 over ten years. I was skeptical of that stat, and upon drilling into the data discovered that this is net of a projected decrease of over 138,000 postal workers.

Now we will discuss the capital market conditions, essential to real estate investors.

Capital Markets: Watch Out! Goat Rodeo Ahead

I'm indebted to John P. Hussman Ph.D. of **Hussman Funds** for that header from his January 30, 2012 weekly newsletter. Hussman defined the term:

> ***Goat Rodeo*** *- Appalachian slang for a chaotic, high-risk, or unmanageable scenario requiring countless things to go right in order to walk away unharmed.*

That is an apt metaphor to describe the current state of the capital markets. So many things must go right that casualties are certain. Many banks have repaired their balance sheets, raised capital, and worked through significant numbers of problem loans. However weaker institutions may be fast approaching their final curtain. We'll take a look at how many are on the firing line and factors that may hasten their demise.

Troubled Banks

The following data is from the FDIC's Quarterly Banking Profile (QBP) Q4 2011 report:

TABLE I-A. Selected Indicators, FDIC-Insured Institutions*	2011**	2010	2009	2008	2007	2006
Return on assets (%)	0.88	0.65	-0.07	0.03	0.81	1.28
Return on equity (%)	7.86	5.87	-0.72	0.35	7.75	12.3
Core capital (leverage) ratio (%)	9.09	8.89	8.6	7.47	7.97	8.22
Noncurrent assets plus other real estate owned to assets (%)	2.55	3.11	3.36	1.91	0.95	0.54
Net charge-offs to loans (%)	1.55	2.55	2.52	1.29	0.59	0.39
Asset growth rate (%)	4.24	1.78	-5.45	6.19	9.88	9.03
Net interest margin (%)	3.6	3.76	3.49	3.16	3.29	3.31
Net operating income growth (%)	44.74	1,632.37	-154.76	-90.71	-27.59	8.52
Number of institutions reporting	7,357	7,658	8,012	8,305	8,534	8,680
Commercial banks	6,290	6,530	6,840	7,087	7,284	7,401
Savings institutions	1,067	1,128	1,172	1,218	1,250	1,279
Percentage of unprofitable institutions (%)	15.52	22.07	30.84	24.89	12.1	7.95
Number of problem institutions	813	884	702	252	76	50
Assets of problem institutions (in billions)	$319	$390	$403	$159	$22	$8
Number of failed institutions	92	157	140	25	3	0
Number of assisted institutions	0	0	8	5	0	0
* Excludes insured branches of foreign banks (IBAs).						
** Through December 31, 2011.						

Source: FDIC

There were 92 failed institutions in 2011. As of this writing (mid-March 2012) there have been 13 failures YTD. This brings the count of failed banks to 430 since 2007. The total number of FDIC insured institutions thru Q4 2011 decreased to 7,357 from 7,658 in 2010. This is a long term trend. There has not been an increase in the number of banks and thrifts since at least 1990 (15,158), which is as far back as the FDIC QPB stats go.

Total Problem Banks	956	100%
Const. & Dev. RE	136	14.2%
CRE Lending	336	35.1%
Residential RE	4	0.4%
Multi-family RE	1	0.1%
Total RE related	**477**	**49.9%**

The FDIC's problem bank list is confidential, however a number of sources compile *unofficial* lists with full information on the institutions.

I prefer the list at **Calculated Risk Blog** because it can sorted by state, name, size, nature of enforcement actions and reason for the listing. The accompanying chart reflects 50% of the problems banks are caused by real estate issues, and 35% specifically in commercial real estate. (Note: the total does not match the FDIC total due to differing metrics to define “troubled”.)

TARP Lives On

Originally, 707 troubled financial institutions received TARP bailouts. As of September 30, 2011, 390 institutions remain in the TARP program, including approximately 370 banks. The outstanding balances are concentrated in a small group of banks, as 25 banks with $11.3 billion, or 65% of the $17.3 billion dollars owed. The largest outstanding amount is $3.5 billion. (A current list of banks with outstanding TARP funds can be found ***here***.)

This is a Goat Rodeo in progress. Many of these have no chance of recovery, and will hang around as zombie banks until the FDIC can afford to close the institutions.

A cautionary note about troubled banks and jumping to conclusions: If the bank you’re researching is on the troubled list, it is *not* an automatic death knell. Many banks hit the list at one time, work through their problems, and go on to operate with no further problems. The trick is to figure out which ones will survive and which won’t, *before* putting your business and sanity at risk dealing with a problem institution. Many factors can affect the final judgment of the financial condition of a particular bank. A thorough review of the bank includes analysis of the bank’s financial statements and regulatory filings; calculation of certain key operating and financial ratios; an analysis of the management team and capital structure, and comparison to the bank’s peer group.

An example: One of our bank lenders is currently on the troubled list and has been since 2010. We went through the analysis as described above. We know the management team very well, and they shared with us the nature of the problems and their plan to cure them. We elected to stay with the bank, and made it a point to do what we could to help them through a difficult period. In early 2011 they let us know they were able to quote loans. We gave them the opportunity to quote a credit-tenant deal, received a very good quote, and closed the loan within 77 days from start to finish. That is exceptional service in any conditions. I know we will benefit from a strong relationship with this bank for years to come due to our ability to evaluate and deal with the relationship in a positive way.

If you would like assistance in evaluating your existing bank(s) or others which you are contemplating doing business, we offer bank evaluation services through the **DealmakersGuide.com** website. Please send an email to info@dealmakersguide.com and put **Bank Analysis** in the subject line so it will come to me.

The Return of Mark-to-Market

Another less-noted development that will help spur dispositions of all real estate types is a new ruling from the Financial Accounting Standards Board (FASB) which sets the standards by which financial institutions must prepare their financial statements. In April of 2011 FASB issued a new directive (Accounting Standards Update No. 2011-02) which requires qualifying lenders to mark property values to market if they do a forbearance agreement or loan workout, as defined in the regulations. (The definition of what now qualifies as a workout is as important as the ruling itself. For geeks, the full text is available *here*.)

This sounds like an arcane regulatory issue, but it is a 180-degree turnaround of the FASB standard issued in 2009 that suspended “mark-to-market” accounting, which allowed banks and financial institutions (including the GSE’s) to avoid marking down the value of their real estate loans and mortgage securities. Those mark-downs would have devastated the financial sector. Now banks have an incentive to liquidate problem loans and properties or face the consequences of increased reserves and lower earnings.

The End of Extend and Pretend

As noted earlier lenders are now selling properties rather than modifying or extending delinquent or potentially troubled assets. The new FASB ruling means the regime of “amend, extend and pretend” begun in 2009, which morphed into “delay and pray” through 2010, is over.

In 2008-2009 the banks took every loan they had and tried to do anything possible to keep it off the non-performing list. Aided by the government and the FASB relaxation of the mark-to-market accounting standard, two- and three-year workouts were the norm. They expected that by 2012 things would be better and the problem loans would take care of themselves. It didn’t quite work out that way.

Andy Miller, principal and CEO of **Miller-Frishman**, a commercial real estate workout firm in Denver CO talked about the state of the distress market for commercial real estate in an interview with **Casey Research** in February 2012:

> One component of our business focuses only on the distressed world, in which we regularly deal with between 50 and 100 banks, from large to small. We’re involved with them in every aspect of distress. We act as receivers, we act as disposition agents, we value the real estate for them and oftentimes I consult with them to just help them understand what they have and what the easiest way is for them to exit while minimizing their losses.
>
> This segment was very busy in 2009. We did many receiverships all over the country, and we were busy into 2010. In about the third quarter of 2010, it completely ground to a halt. We saw no distress. We saw no hysteria. It was as if within a span of 90 or 120 days the entire world righted itself. It was one of the weirdest things I’ve ever seen, and it lasted for an entire year. Our business in the distress world was totally dead around here from about October of 2010 to November of 2011. Dead. I don’t think we picked up a single property.
>
> All of a sudden, right after Thanksgiving in 2011, the floodgates opened again. In the last six weeks we probably picked up seven or eight receiverships – and we’re now seeing some really big-ticket properties with major loans on them that have gone into distress, and they’re all sharing some characteristics in common. In 2008 and 2009, these borrowers were put on a workout or had a forbearance agreement put into place with their lenders.

Most banks have repaired their balance sheets, and now have an incentive to liquidate problem loans and OREO’s. This sets the stage is set for higher transaction volume in distress property and non-performing notes. The bank’s best buyer prospects are its own customers who have weathered the downturn and have an appetite for acquisitions.

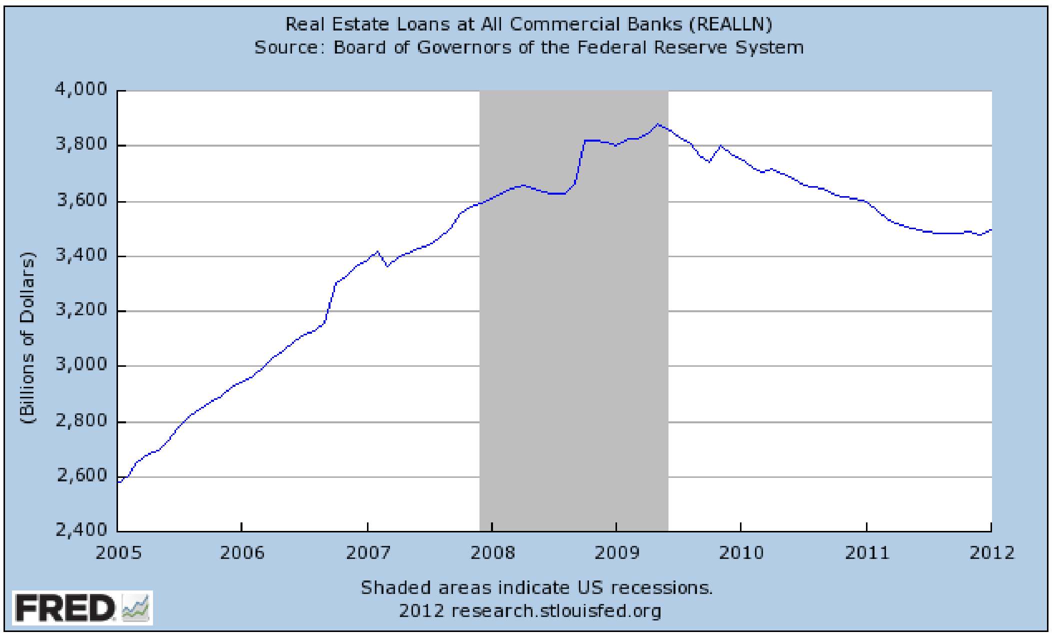
In recent weeks I’ve had calls from three of my banks with notes for sale, secured by properties they do not want to foreclose on because they know there is a huge loss waiting on the auction block. The bank would sell the note at a discount—even if they have to finance the purchase—and minimize the loss. Buyers then deal with the borrower on whatever terms can be negotiated. The deal I looked at this week is leased with a long-term tenant paying above market rent; the note is in default and can be foreclosed immediately. We could use the property if it were to become vacant, so I’m tempted.

This is a nationwide trend. Brokers I talk to around the country are reporting a significant uptick in calls from banks looking for non-performing note buyers. I expect the volume to increase significantly, especially around the end of each quarter when financial statements must be filed and reserves recalculated.

If you haven't heard from your bankers lately, give them a call and ask the question, "What's the biggest problem on your list you would like to get rid of today?" You may be the best call that banker gets all week.

Bank lending on the uptick

Total real estate lending is stagnant, and according to data from the St. Louis Fed (next page) actually fell about $1 billion in 2011 from 2010.



Last Data Point: Dec. 31, 2011

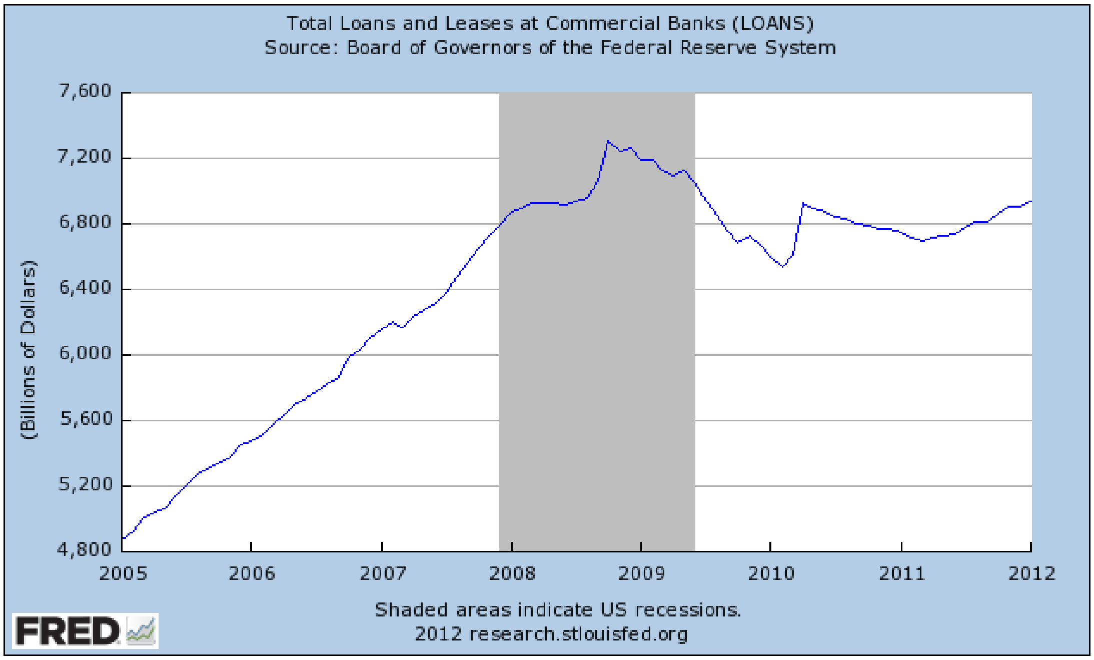
This doesn't tell the whole story. Many banks are eager to lend, however equity and experience are prerequisites. Last year I wrote of increased interest by our local banks in making CRE loans, and I was optimistic that 2011 would be the year the tide turned for CRE borrowers.

My optimism proved out. In 2011 we closed two improvement/construction loans for assets we acquired with the intent of significant renovation and expansion, funded another acquisition, and extended or converted numerous credit lines with no reductions or required curtailments. Our existing relationships were the critical factor in each of the transactions. Strong banks are eager to lend, but primarily to existing customers with whom they are comfortable as to capital, experience and management.

Another personal experience illustrates the last point. In 2011 we attempted to develop relationships with two new banks to the area, but were unsuccessful with both. One bank could not get comfortable with our ownership structure. In the second bank we actually had an existing loan assumption, ironically initiated in late 2008 with our acquisition of a troubled asset, but regulatory problems with CRE loans precluded their ability to fund further improvements. Fortunately we have several strong community banks in our area with which we have decades of experience, and moved the loan to another bank.

A recent conversation with a loan officer in a super-regional bank told me he has a lot of loan requests, but not many closings. Underwriting standards remain tight even for seasoned borrowers. Expect to show everything about your financial life for the past three years, with complete documentation. Anyone who has recently approached a lender for CRE financing knows what I'm talking about.

The next graph indicates loan volume is sideways rather than the steep decline experienced 2009 through early 2010. (Note: the steep increase in 2008-2009 was due to businesses drawing down credit lines when commercial paper markets ground to a halt.)



Last data point January 1, 2012

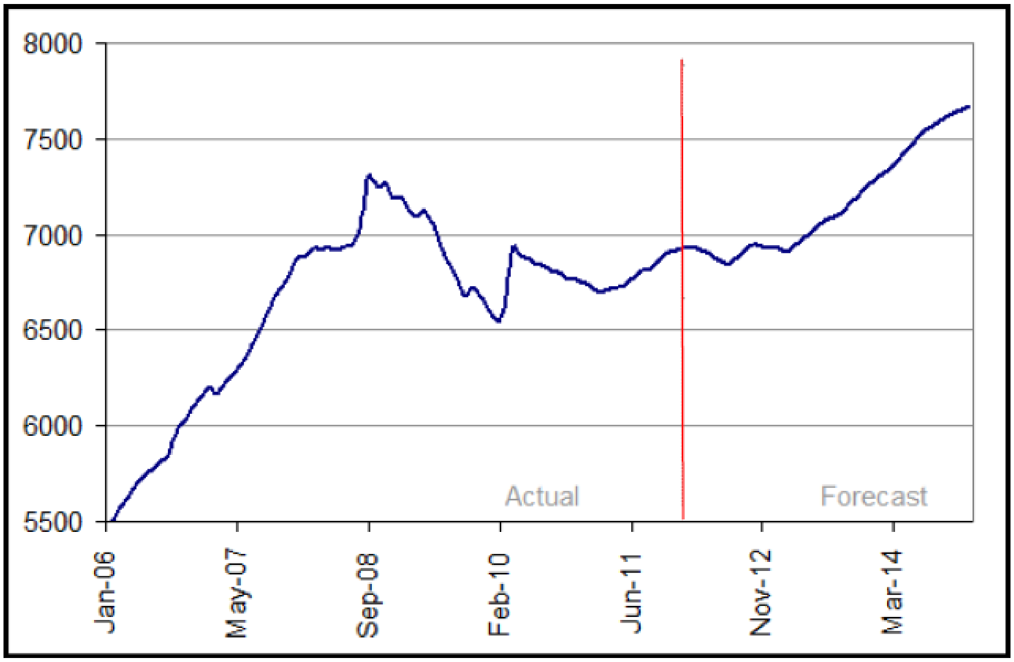
An excerpt from the FDIC QBP through Q3 2011 indicates increases in lending for all but real estate construction loans:

> Total loans and leases increased for a second consecutive quarter, rising by $21.8 billion (0.3 percent).
>
> The largest growth was in C&I loans [Commercial & Industrial; i.e. owner-occupied and business financing], which increased by $44.8 billion (3.6 percent). This is the fifth consecutive quarter that C&I loan balances have risen. Residential mortgage loan balances increased by $23.7 billion, the largest quarterly increase since third quarter 2007. Real estate construction loan balances fell for a 14th consecutive quarter, declining by $20.3 billion (7.4 percent).

In the near term (2012) the forecast for total bank credit is slightly negative, returning to growth in late 2013.

The following graph from Financial Forecast Center reflects a projection of total loans and leases:

U.S. Total Loans and Leases Forecast Trend
Past Trend Present Value & Future Projection; Billion USD; SA;
Forecast period Jan. 2012—Jan. 2015



Source: www.Forecasts.org Updated Monday, February 13, 2012

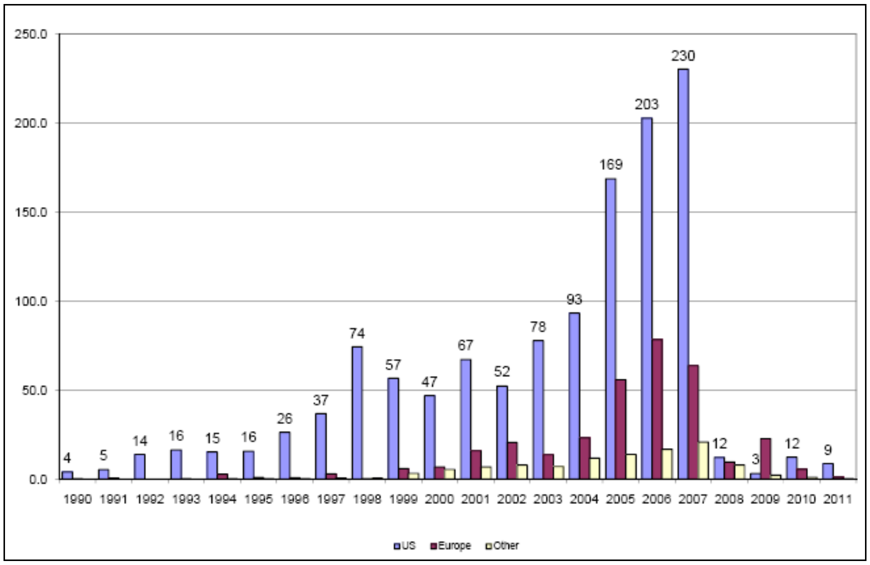
Looking further into the current conditions of commercial real estate finance, the capital markets as a whole are still in disarray due to the nationalization of residential financing, and the continued absence of securitized financing, which is our next topic of discussion.

Commercial Mortgage Backed Securities (CMBS)

Securitized finance is the preferred exit strategy of direct investors in commercial real estate. These are non-recourse, fixed-rate loans priced at spreads over Treasuries. The loans typically have 20–30 year amortization and typical terms of 5-, 7- and 10-years.

Commercial Mortgage Backed Securities (CMBS) began in 1990 as a result of the government's efforts to liquidate the loans from the RTC (Resolution Trust Corporation) left from the S&L crisis. CMBS grew to the point it captured a major share of commercial real estate finance, hitting a peak in 2007 of $230 billion in the US.

Then the sector collapsed in the financial meltdown of 2008. The following chart (next page) is from 2010 and shows the annual volume of CMBS loan originations since 1990:



Source: http://www.crefc.org/IndustryResources.aspx?id=13086

According to CMSA (Commercial Mortgage Securities Association), 2011 loan volume finished at about $32.5 billion, below expectations of $50 billion. Estimates for 2012 range from $20-$50 billion. The safe bet is for issuance to be flat with 2011 at about $35 billion. A report from Jim Flaherty is CEO of CMBS.com, from the CREFC convention in January 2012:

> More than one panel talked about the headwinds facing the industry in 2012. In addition to things we cannot control (like the world markets and interest rates), one of the most interesting headwinds our industry is facing is a wave of loan maturities from 2007.
>
> Without a doubt, 2007 was the peak of the market with lax underwriting and excessive leverage. There are about $20 billion worth of loans originated in 2007 that mature in 2012 and the losses on these loans might reach 50 percent. The headlines that these defaults make will not help investor sentiment.

Overall CMBS delinquencies reported by Trepp LLC in January 2012 indicate no significant change from last year.

> The delinquency rate for U.S. commercial real estate loans in CMBS fell six basis points in January to 9.52%. The value of delinquent loans is now $57.7 billion. The first wave of 2007 originated loans that reached their balloon dates in January performed poorly, with only 27% of these loans managing to pay off. While this should have pushed the delinquency rate much higher, this upward pressure was offset by about $1.6 billion in loans that were resolved with losses during the month.

CMBS market performance will be dictated by two trends going forward,” said Manus Clancy, senior managing director at Trepp.

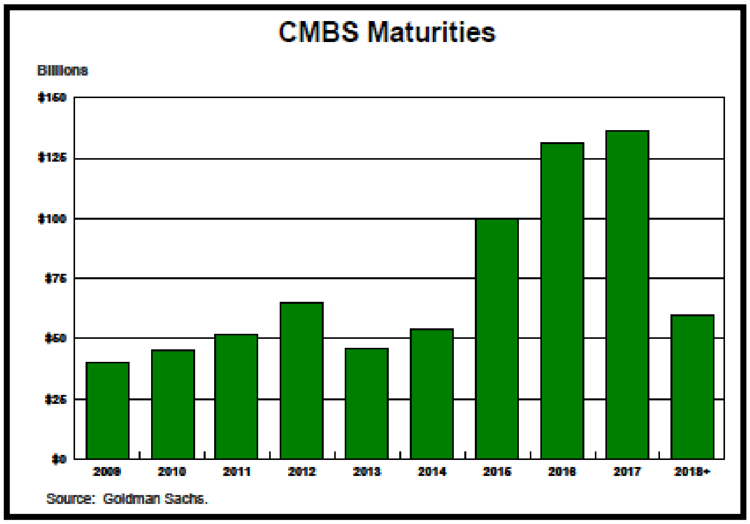
Property Types - % 30 Days +

	Jan-12	Dec-11	Nov-11	3 mo.	6 mo.	1 yr.
Industrial	12.14	12.03	12.20	11.59	11.09	11.68
Lodging	12.09	12.20	12.28	14.12	15.04	13.87
Multifamily	15.39	15.57	16.18	16.73	16.94	16.48
Office	8.90	8.97	8.76	8.95	8.17	7.35
Retail	7.88	7.85	7.52	7.61	7.85	7.82
Overall	9.52	9.58	9.51	9.77	9.88	9.34

Source: Trepp®

“The pace of loan liquidations will compete against the growth of delinquent loans that emerge from the Class of 2007. If the rate of loan liquidations slows, the rate will climb. If the special servicers keep plowing ahead at the pace they did in January, the rate could manage to stay flat.”

This is not a significant change from a year ago. In February 2011 overall delinquencies were 9.15%. But (there always seems to be one), the bulk of CMBS maturities for loans originated during the boom are still to come. And note the multi-family delinquency rate of 15.39%. There will be acquisition opportunities for well-capitalized buyers to purchase various levels of debt and properties in the multi-family sector.



The chart at left depicts 2012 CMBS maturities of about $60 billion. The correlation of maturities with the years of issuance in the boom years shown on the chart from the preceding page can be seen clearly in the maturities five and ten years later, i.e. 2012 and 2017.

A report from RE Business Online during a panel discussion at MBA's commercial and multifamily real estate finance conference in Atlanta (January 2012) sums up the importance of CMBS to the commercial real estate markets.

"To say that the CMBS industry has been on a roller coaster ride the past few years would be an understatement. After annual U.S. CMBS issuance reached a high of $230 billion in 2007, issuance plummeted to nearly $3 billion in 2009 amid the global credit crunch before rebounding to approximately $30 billion in 2011. The conservative estimate for 2012 is for volume to range between $40 billion and $50 billion.

One roadblock to the revival of CMBS is the role of ratings companies in the process. Without going into head-numbing detail, the Standard & Poors woke up to the liability of issuing ratings on CMBS loans and changed the rules for issuers. This stopped the revival of CMBS in its tracks last year. This is another Goat Rodeo in progress. Until this issue is resolved multi-payer CMBS is stuck in limbo.

"We have to make CMBS work for the overall real estate recovery to work. Otherwise, we're going to have a handful of really good markets and a lot of markets struggling because you are not going to see the life companies and the banks real active in some of these markets," explained Custis. "They are only going to be willing to do 50 percent loan-to-value, and that is going to leave a lot of borrowers in a pretty tough position."

An expected increase in acquisition activity will prove to be a big boon for the industry, said Kevin Pivnick, panel member and director of Deutsche Bank National Trust Co.

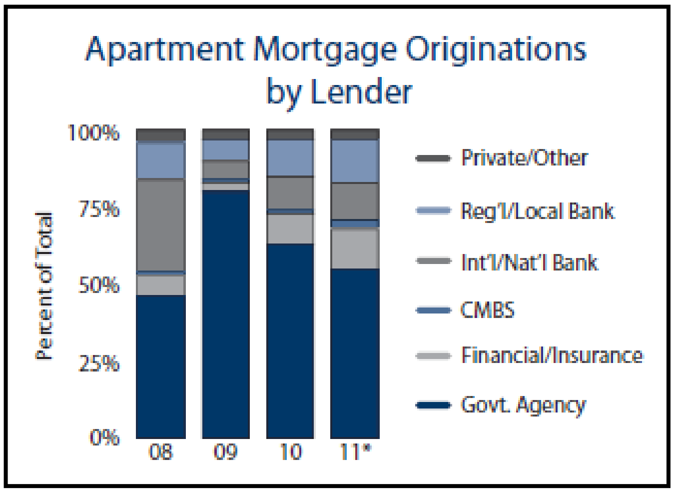
> "CMBS is really tailor-made for a highly acquisitive environment where people need to close quickly and use a lot of transparency in the process, and they want a little bit higher leverage," explained Pivnick. "It's our view that we will get an outsized portion of the increased acquisition activity that we know is coming around the corner."
>
> —*Source: http://www.rebusinessonline.com/main.cfm?id=22193*

Government Agency and Life Company Lending

Nature abhors a vacuum, and the principle extends to capital markets. The gaping hole left by the 2008 collapse of CMBS lending in the commercial property capital stack has not gone unfilled. The two most active lender groups in 2011 were life insurance companies and the GSE's—Government Sponsored Enterprises, also known as FannieMae and FreddieMac. (In addition, the government issues loan guarantees through FHA, HUD.) CRE lending for life insurance companies for 2011 was about $60 billion, a slight increase over 2010.

Of course the GSE's have been nationalized, and estimates are that about 90% of the single-family residential mortgage market is controlled by the two entities. In addition, the GSE's became the go-to lender for the multi-family sector. Speaking of the high delinquency rate of CMBS multi-family loans depicted in the Trepp LLC data above, Zanda Lynn, managing director with Fitch Ratings, said, "The delinquency rate on CMBS multifamily loans has always been relatively high compared to the delinquency rate on Freddie Mac loans, said Lynn. That's the case even if some of the largest troubled securitized loans aren't factored into the equation. Quite frankly, when a multifamily deal comes in a pool [of CMBS loans], we're always asking, 'Why didn't they get Freddie financing?'"

Indeed, the GSE's have dominated multi-family lending, but their share is decreasing. The 2012 National Apartment Report from Marcus & Millichap details the change.



"GSE originations accounted for a 55 percent share, a decline from last year, as life companies, CMBS and banks each gained market share of 200-300 basis points.

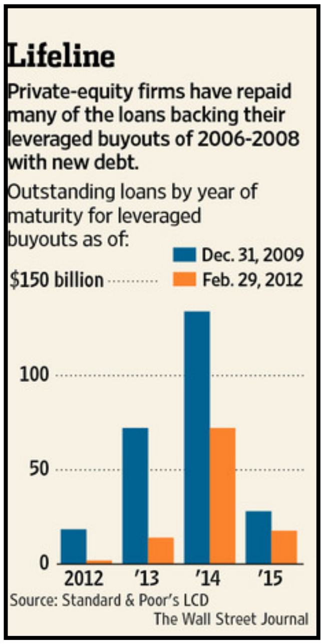
Total multifamily debt outstanding has reached $806 billion, of which GSEs hold approximately 41 percent, while banks and life companies hold 27 percent and 6 percent, respectively.

The GSE's will have unlimited federal financial support through December 31, 2012, but Congress will debate a number of proposals to sunset Fannie Mae and Freddie Mac over the next decade and privatize the secondary mortgage market." --*Source: Marcus & Millichap NAR 2012*

Capital Demand Alert: 2012–2014

In light of the above data, my warning from last year regarding capital availability 2012-2014 was right on target.

To recap, I stated that a bubble of loan demand will occur in 2012 from outside the real estate markets that investors should be aware of and act accordingly. The Leveraged Buy Out (LBO) industry, led by private equity firms, originated hundreds of billions in debt from 2007–2008 with 5- to 7-year maturities. I predicted a rising demand for capital to refinance these loans.



The biggest players foresaw this and started early last year to restructure their loans. For example, the Blackstone Group, with almost a trillion dollars in assets under management, began early negotiations for loan extensions two years ago (2010) because they saw the threat of a demand bubble. Right on cue, the private equity world is busy with refinancings. The chart at left from the *Wall Street Journal* confirms the trend.

An estimated $363 billion of commercial and multifamily real estate loans will mature in 2012. Nearly 63 percent of maturing loans are considered "underwater." Banks hold nearly 59 percent of maturing loans; another 15 percent are held in CMBS.

My suggestion is that if you have loans maturing in the next two years, emulate the big players and start the process of finding a new loan now. Qualify the banks you are dealing with as previously discussed. Allow extra time to navigate the underwriting process. I've seen deals take up to twice as long to get closed because of financing delays.

Interest Rates

The debate continues as to which scenario will play out: a continued regime of super-low interest rates driven by lack of demand and a deflationary economic outlook; or a significant increase in rates brought about by high inflation caused by central banks exponentially increasing money supplies and "bond vigilantes" punishing governments for record deficit spending.

I attended John Mauldin's Strategic Investment Conference in April of 2011 and this was the question of the day. David Rosenberg quipped, "On the question of whether there will be inflation or deflation, I can say for certain we will have 'flation."

Added to the mix this year is the new policy of the Federal Reserve to be more transparent in when the central bank will act to adjust rates. In January 2012 Chairman Ben Bernanke announced the Fed will keep rates low through 2014. In his January 28 newsletter John Mauldin commented that this is not good news.

> "Telling us that rates will stay low for another three years has a lot of negative implications. First, it says that the Fed does not expect a recovery of any significance during that time. Second, it tells any individual or business that there is no reason to hurry and borrow money to get lower rates. You can wait and see how things turn out before you decide to act. [...] The headlines talked about the Fed keeping rates flat into 2014, but if you look at their median forecast, they expect rates to rise by all of 0.5% at some point in 2014."

The arguments are not merely academic. The low-rate conditions present real and lasting stresses on savers, fixed income investors and commercial banks via compressed interest rate margins.

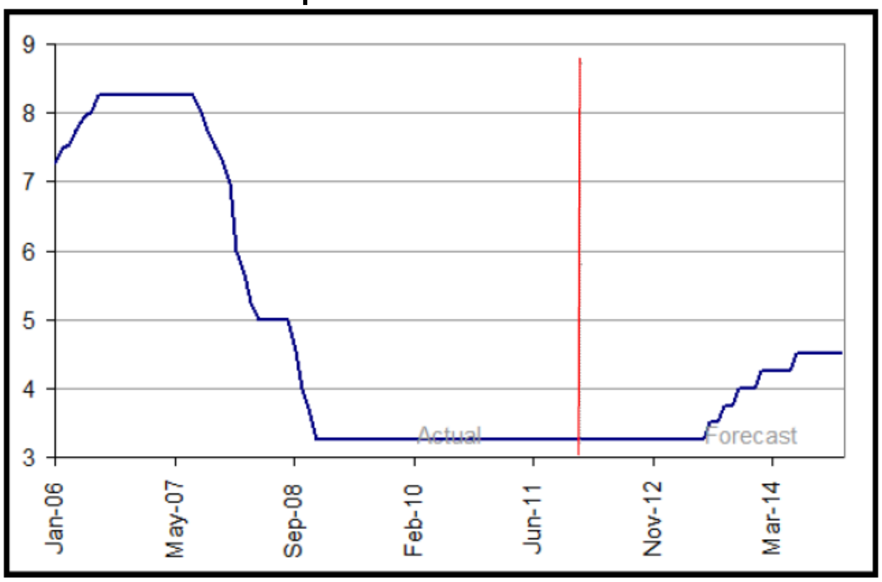
For our purposes we will concentrate on the outlook for two sets of interest rate data: the Prime Rate and the Treasury market. These directly affect the availability and cost of debt capital to direct CRE investors.

Prime Rate

Historically the Prime rate is the rate charged by banks to its best customers. Currently it is set at three points above the Fed Funds rate, the rate that banks receive on deposited reserves. But the current Prime Rate of 3.25% is below banks' cost of funds. As can be seen in the FDIC chart on page 18, net interest margins for banks have averaged around 3.5% for years. What that does not show is that in order to preserve that margin and still cover overhead and servicing costs most banks have a floor rate of around 4.5%. Most life company and bank loans are quoted with rates in the five's.

The following graph is the historical and forecast Prime Rate. The forecast calls for rates to begin rising around July 2013, well ahead of the Fed's stated window.

Prime Loan Interest Rate Forecast Trend
Past Trend and Future Projection
Forecast period Jan. 2012—Jan. 2015



Source: Forecasts.org; updated Feb 12, 2012; red line indicates forecast date

Last year the consensus forecast of analysts was for rates to begin rising in Q2 2012 at a slow pace, with Prime going to 4.5% by January 2014. Obviously that did not come to pass, and the Fed's successive rounds of Quantitative Easing (QE) had the unintended consequences of creating a bubble in commodity prices. As soon as QE2 ended, Treasury rates promptly fell to record lows.

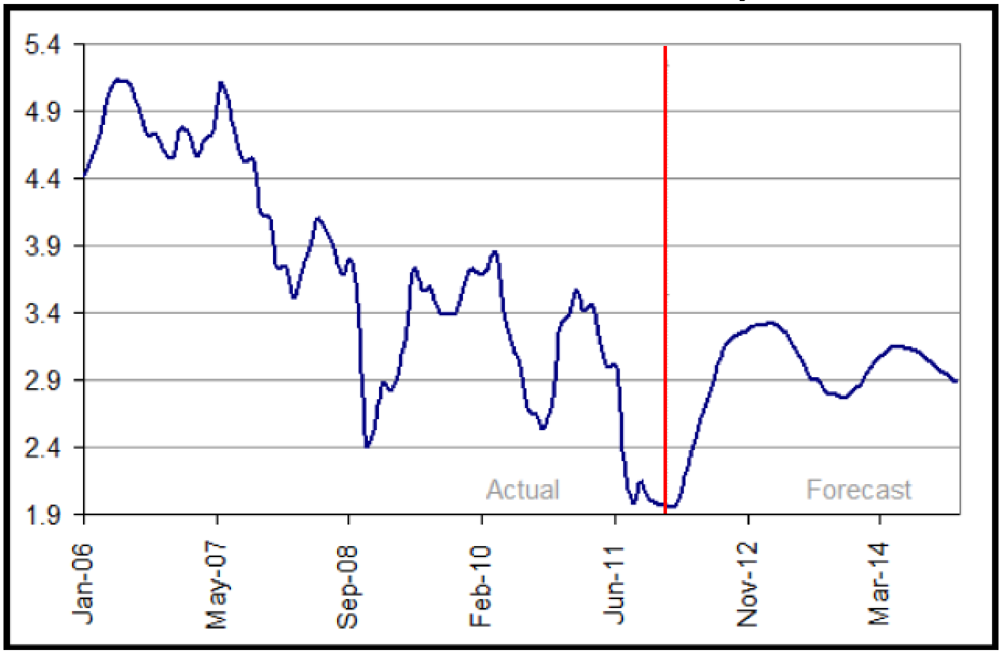
It is almost unheard of for the Fed to raise rates in a Presidential election year, so I feel certain there will be no increase in the Fed funds rate which governs prime. However, the Fed has hinted at a new round of monetary stimulus known as Operation Twist, in which they enter further out the yield curve and exchange short dated treasuries for long dated bonds, thereby decreasing long term rates. Most analysts believe the bond market will have some say in that scenario.

Treasury Rates

In commercial real estate the ten-year treasury is the most watched interest rate. The US 10-year is also the world's preferred investment in periods of high unrest or geopolitical uncertainty.

As of this writing (late February 2012) the 10-year Treasury rate is hovering around 2% after reaching a historic low of 1.72% on September 22, 2011. (Trivia point: the highest-ever rate for the 10-year was set on September 30, 1981 when it reached 15.84%)

Ten Year U.S. Treasury Securities Yield Forecast Trend
Past Trend Present Value & Future Projection



Source: Forecasts.org (FFC); Update February 12, 2012; red line indicates forecast date

According to this forecast above, beginning in Q2 2012 the 10-yr. rate is projected to begin a march back to 3.3% at year end 2012. I disagree. This is an instance where reversion to the mean in models can result in missing exogenous conditions. Specifically, as the primary target of a flight-to-safety in periods of high uncertainty the 10-yr. rate will be artificially low during until the crisis passes.

Color Me Skeptical

I submit that there could hardly be any more points of major uncertainty around the world today. In the discussion of the macro economic forecast for the US I left out any discussion of the continuing Eurozone debt crisis and almost 100% probability of a Eurozone recession; the Iranian nuclear threat and its effect on world oil prices; and the expected hard fall of the Chinese economy to a much lower growth path. These are the top three on my worry list, and each has the potential to disrupt important sectors of the global economy. In my view the Eurozone problems are most likely to occur first and have an impact on the US. A collapse of confidence in the banking system due to sovereign debt is already causing capital to seek shelter. A recent article in the Wall Street Journal detailed the movement of funds from European central banks to safe havens.

David Rosenberg of Gluskin Sheff, a Canadian money manager, said in an interview in February 21, 2012, “If you are going to tell me that Europe is going to go through a recession and we are going to remain unscathed, color me skeptical.”

I agree with Rosenberg, and while I understand the thinking that says the inflation rate must push up bond prices (a factor that drives the computer model in the FFC chart above), I think the unrest in Europe and the Mid-East will play out to put continued downward pressure the US bond market for some time to come. When this ends I don't know. But it's not this year. I will stick with my forecast of a ten-year rate in the neighborhood of 2% for the year.

And given the already low rates producing negative yield in short-term durations, additional buying in a flight-to-safety will further influence US bond rates further out the yield curve. Rosenberg went on to say regarding choosing investments in such a troubled environment, he emphasized *scarcity value*.

> "**You want to own what is scarce and in demand—and that, right now, is income.** This is especially relevant for the capital appreciation demographic—a segment of the population between the ages of 25 and 49 who have demand for income and stable cash flows. And I like the long bond [the 30-year Treasury]; it's the only place you can actually get yield. [But] we are not just talking about Treasuries or corporate bonds. We are talking about MLPs; we are talking about REITs. Even hard assets work well in uncertain environments." *Source: Advisor Perspectives-"David Rosenberg: Searching for Certainty in a Sea of Uncertainty" by Katie Southwick; February 21, 2012 [Emphasis added]*

Hello—that's a noted money manager talking about our asset class. Dan Chamberlain, COO of 37th Parallel Properties adds, "the demand for income is even more urgent among the older demographic of baby-boomers, and a prime factor that will drive demand for income-producing real estate for many years to come".

Equity: the other side of capital markets

There is a silver lining to the tight credit and reduced access to debt capital. I wrote in 2009 that the *Decade of Debt* was over, and the *Era of Equity* would be the dominant factor in real estate investment over the next decade. I watched this happen in the late 1980's as the real estate markets were flooded with oversupply created by the liquidation of failed S&L's, itself an unintended consequence of the 1986 tax reform act which eliminated passive losses. The rise of the REIT's was fueled by the flow of equity capital into vulture funds which specialized in acquiring distressed investments.

Income producing real estate uses leverage to produce above-market returns, but leverage also increases the risk profile of the investment. As conditions change from easy-money, low-rate debt capital, the other side of the equation increases the amount of equity deployed at a higher risk premium to achieve the same effect. While debt capital remains historically cheap, tighter lending policies and the lack of a viable CMBS market have reduced access, and raised the percentage of equity required to finance acquisitions.

This would normally have the effect of requiring a higher return (via lower price) on the asset in order to accommodate the equity risk premium. But as noted previously, investors worldwide are chasing income. Further, burned by the bubbles of the last decade in stocks, commodities and perhaps the current bond market, investors are looking to tangible assets that produce steady, safe cash flows. Income producing real estate has all of the above and the added feature of tax benefits in some structures.

The current environment has driven the demand for income and yield to new highs. Capital is flooding into funds of all types. The National Association of Real Estate Investment Trusts reported, "In 2011 REIT's issued $37.5 billion in initial and additional common and preferred shares last year. That was up 32% from 2010, and was the largest amount of REIT stock issued since the securities were established in 1960. The previous record was in 1997, when $32.7 billion of REIT stock was sold to the public."

I am not going to examine REIT returns and performance as my focus is on direct investment. A wealth of information is available at National Association of Real Estate Investment Trusts® (NAREIT). Suffice to say the sector has out-performed the market over the last few years, and poised to continue the performance along with the trend of improving market fundamentals.

However, the public REIT market is a proxy for capital trends. The flow of funds into public REITs is mirrored by new opportunities in private capital markets and the rebirth of syndication structures to pool investors' equity in an investment property. We will discuss this in more detail in Part 2.

Summing Up

We've spent a lot of time examining the macro factors facing the economy at large and its effect on commercial real estate in particular. It can be summed up to a few bullet points:

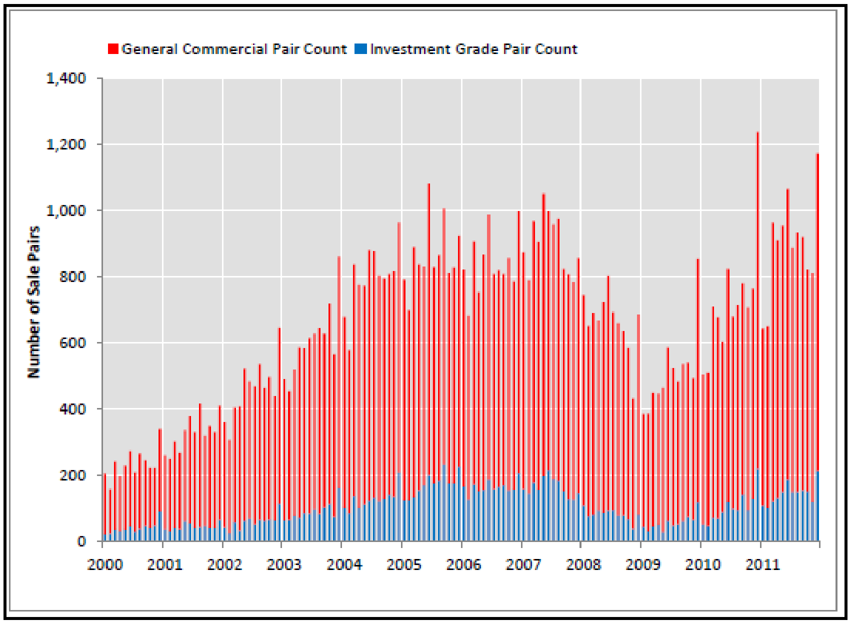
- The housing markets will continue to act as a drag on job creation, retail sales and economic activity
- The continued decline of home ownership and overarching demographic trends will act as a demand stimulus for multi-family properties for the next several years
- Employment growth is weak and geographically uneven, but concentrated in sectors that benefit multi-family and office properties
- Nominal household income is flat. Inflation adjusted HH income is negative, which will hamper growth in discretionary spending, housing and luxury items
- The banking industry is still working through problems. Tight credit and underwriting standards will constrict the availability of credit at all levels
- The low-rate environment has investors searching for yield, and commercial real estate is an attractive asset class for investors of all sizes
- Equity is rising to the top as the preferred source of investment capital

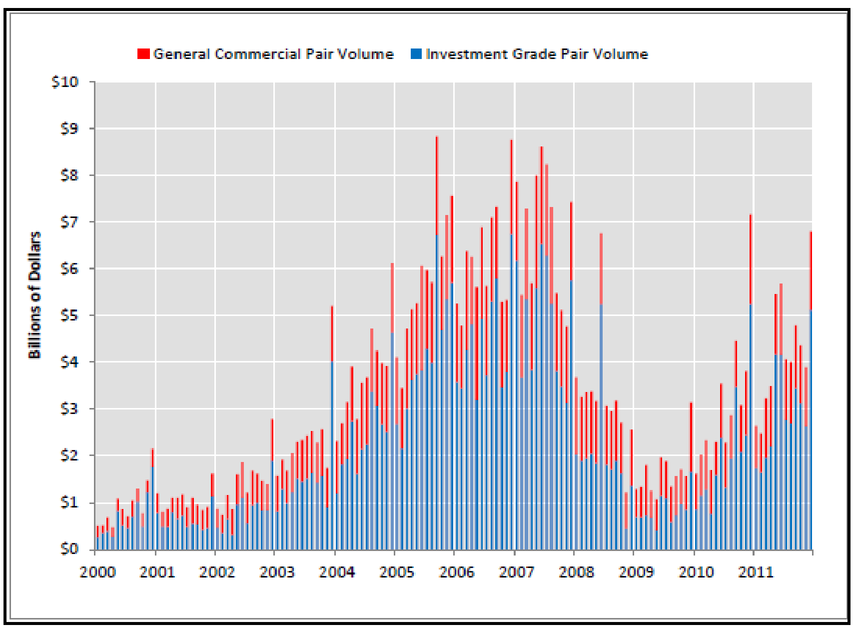
Next we will examine how these trends affect specific commercial real estate property types.

Part 2: Forecast by Property Type and Region

2011 Transaction volume
2011 Valuations
Multi-family outlook
Office outlook
Retail outlook
Exit Strategies: accessing equity
Resources

General commercial real estate transaction volume rebounded off the 2009 lows and the trend that started building in 2010. The number and dollar value of commercial real estate transactions finished well above the 2009 trough.



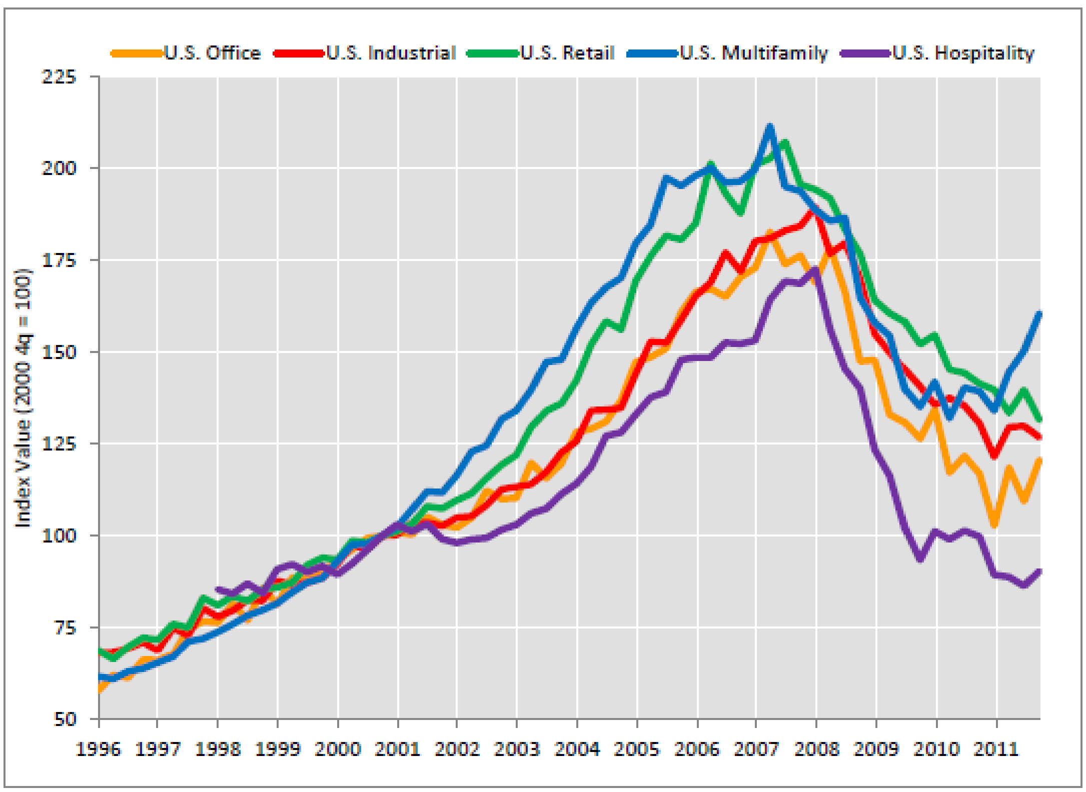


Source: CoStar Group CCRSI Report February 2012. See FAQ for methodology

Valuations continued to improve through 2011, even in the face of slowing transaction volume toward year-end. The following commentary is from the February 2012 Costar Commercial Repeat-Sale Indices report for Q4 2011:

- The multifamily segment has been the best-performing segment over the past year and is the only index to record positive gains in 2011 across all regions.
- The office segment tallied the second-best growth rate in 2011. Gains on the office regional indices ranged from 8% in the West to 11% in the Midwest and Northeast, although the South Office index recorded a 4% pricing loss in 2011.
- Retail was universally the worst pricing performer in 2011. All regions produced pricing losses in 2011, ranging from a 1.2% cumulative decline in the West to a 10.3% cumulative decline in the South.

U.S. Property Type Quarterly Indices through December of 2011



Source: CoStar Group CCRSI Report February 2012

Regional performance

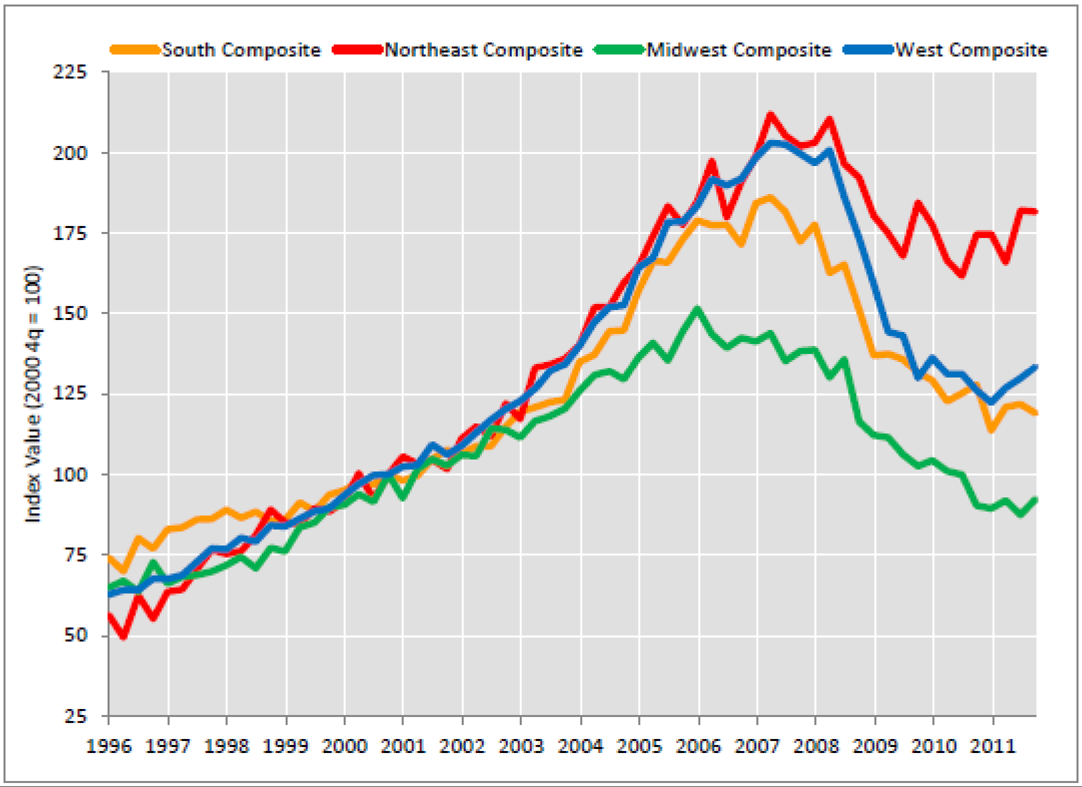
The recovery in commercial real estate values has been geographically uneven, but all regions are on the uptick. The difference is marked by the degrees of improvement. From Costar:

- Among the four U.S. regions, the Northeast has advanced the furthest in its pricing recovery through December 2011. Having gained 12.3% from the recent market trough, the Northeast Composite Index ended the fourth quarter of 2011 only 14.3% below its peak of the last cycle.

- Pricing in the South, Midwest, and West regions is recovering at a more moderate pace. The composite indices for each region finished December 2011 down between 34% and 39% from the peak of the last cycle.

- The West Composite Index, while still well off peak levels, demonstrated the fastest rate of improvement among the four regions in 2011. The West regional index advanced by 5.8% in 2011 versus a 4% gain in the Northeast, a 2.2% gain in the Midwest, and a 6.9% loss in the South.

U.S. Regional Quarterly Indices through December of 2011



Source: CoStar Group CCRSI Report February 2012

Outlook by Property Type

The previous discussion was about valuations and pricing. Now we turn to property fundamentals.

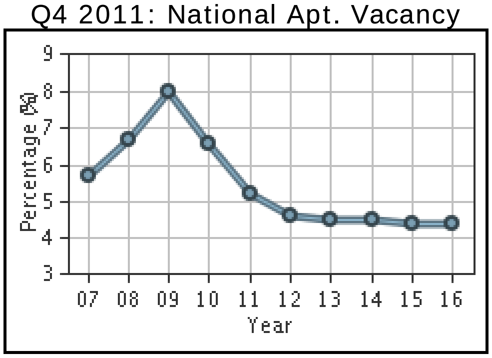
Multi-family: We discussed the macro trends in housing concerning multi-family in Part 1. To recap, the turnaround in multi-family fundamentals is significant. Demand is coming from all directions, including foreclosure refugees, echo-boomers, and empty-nesters. Supply is constrained by the lack of development funding for any speculative projects, producing superior pricing power in rents.

There are overarching lifestyle trends that will contribute to increased demand for rental multi-family housing. The emergence of the Gen Y generation—84 million strong—will bring a different expectation for housing. This is a socially conscious generation, more in tune with the WWII hero generation than the iconoclastic baby-boomers. Gen Y preferences will be for environmentally friendly, energy efficient, low-impact buildings. They are teamoriented, and prefer working and playing together. Smaller living spaces combined with more public space complement locations in proximity to mass transit, 24/7 walkable communities with nearby services will support mixed-use projects. (I see these traits in my son, age 22, who just graduated from college this year. I have been amazed at his large circle of friends, many from high school, and through social media they keep up with each other to a degree my generation actually avoided.)

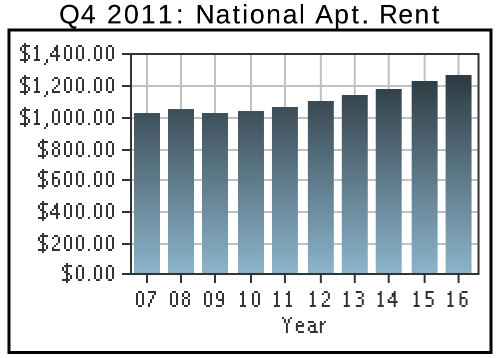
Living patterns are changing to gravitate toward cities rather than suburbs. New census estimates as of July 2011 highlight a shift in population trends following the housing bust and increased energy prices. The annual rate of growth in American cities and surrounding urban areas has surpassed that of exurbs for the first time in 20 years.

Performance fundamentals for multi-family confirm the demand trends. On a national basis vacancies are decreasing and rents are increasing.

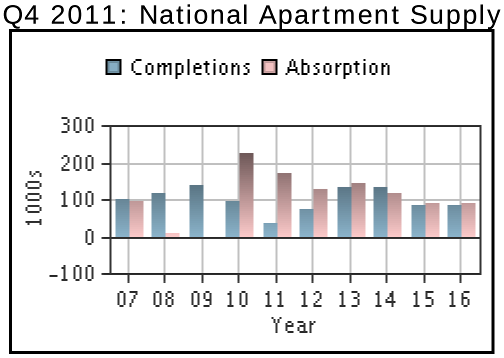
Q4 2011: National Apt. Vacancy



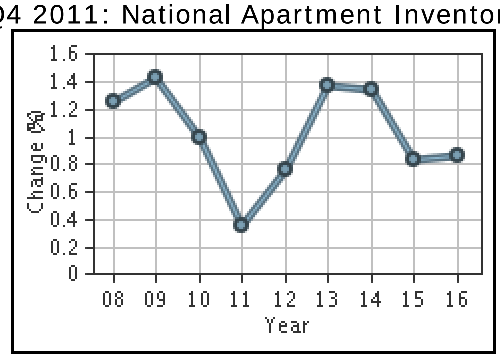
Q4 2011: National Apt. Rent



Q4 2011: National Apartment Supply



Q4 2011: National Apartment Inventory



Source: www.Reis.com

The present and forecast fundamentals for apartments are extremely positive, much more so than a year ago. Vacancies are approaching a cyclical low (<5%), and as vacancies decreased rents continued to rise in 2011.

Bear in mind that forecast rent and vacancy are based on forecast supply levels. 2011 completions of new supply were below 100,000 units. I think the REIS forecast of net supply below 100,000 is too conservative in forecasting 2012. As previously stated I believe supply will increase to over 200,000 units annually in 2012 through 2015. Demand will likely keep absorption levels below new supply until about 2014.

I'll repeat a caveat from the 2011 report:

> Beware over-building on a local level. The typical cycle for apartment supply and demand ratios to cross is about seven years. As rents and occupancies rise it gains

quick attention from developers. The permit-to-completion process is an average of about 18 months. New projects will continue to be developed until absorption catches up and the rate slows.

Usually the lag time produces more units than can be absorbed without rent cuts for about 18 months after the peak level of demand. This creates a typical cycle of about 3–4 years before a market is overbuilt. Absorption then takes 2–3 years to catch up, and the cycle repeats.

I've watched multiple cycles in different markets for over 30 years. The time to acquire apartments is now. Don't wait to buy after development activity is at full throttle. That puts the buyer in the position of flat rent growth in the first year of ownership.

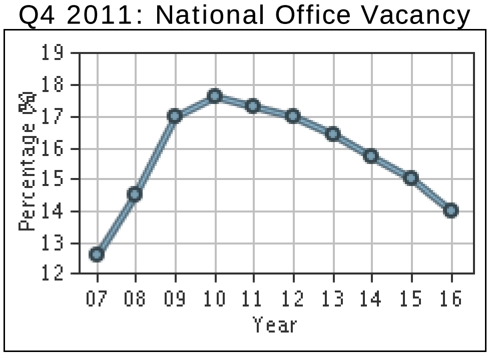
This is a critical factor in market due diligence. Increases in building permits for multi-family will impact existing property fundamentals in a 9-12 month time frame.

Office

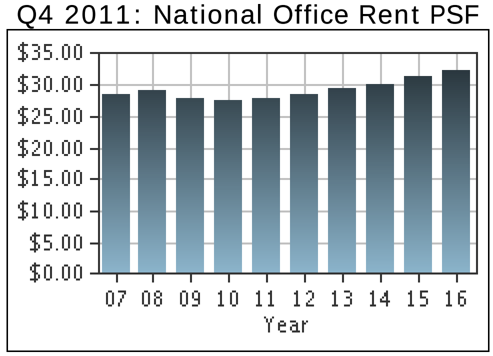
(In full disclosure, my company's portfolio has shifted to about 60% office properties over the past six years, which is to say the following bullish outlook is at risk of my own confirmation bias.)

On a national basis the stats for Office sector are generally positive. Vacancies are falling and rents rising, though slowly. The following chart depicts the net activity through Q4 2011.

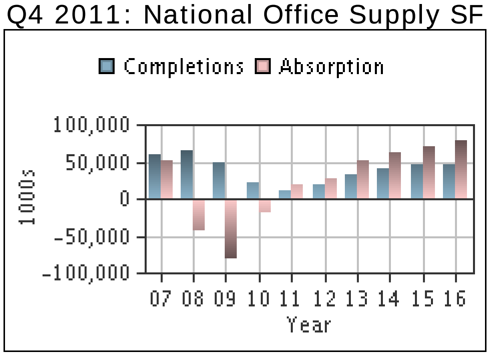
Q4 2011: National Office Vacancy



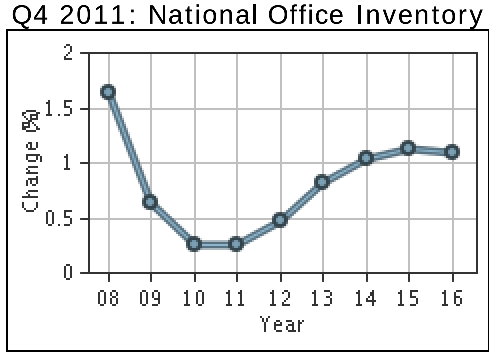
Q4 2011: National Office Rent PSF



Q4 2011: National Office Supply SF



Q4 2011: National Office Inventory



Source: www.Reis.com

Notable changes in conditions from 2011 include:

The boomlet in government use of office space is over. Fiscal restraints are affecting every level of government, and with no new stimulus on the horizon the tide of expansion has likely peaked. In my state every agency is required to examine options for consolidation into buildings with other state agencies prior to negotiating new leases.

The fall in government demand has been offset by increased activity as growing firms in the technology and professional services sectors move up in space quality and quantity, and firms in decline such as financial and real estate brokerages continue to downsize.

Combined with very little new development, the net effect was increased space absorption over supply. This trend should continue through Q2 & Q3 2012. However given the amount of uncertainty regarding the election and the issues facing Congress in January 2013 I expect to see a general hunkering down of firms in Q4, lasting at least through Q1 2013 until at least major issues are resolved.

Office Outlook

The Office sector is more sensitive to job growth than income. Unless employers are hiring, net absorption levels will fall. The forecast absorption levels are positive, partly due to the lack of overbuilding.

The falling unemployment rate is (9.2% to 8.3% YoY). The highest job gains are in administrative support and temporary services, both office users. Growth in professional services—specifically legal, medical and accounting—have been above trend and forecast to continue. The market bright spots confirm the data.

Medical office buildings (MOB's) continue on a bull run. In response the investor demand for MOB's is growing to rival retail single-tenant net-lease properties. Supply is projected to increase significantly, fueled by two overlapping trends.

First, though the Obamacare health insurance mandate is now under deliberation by the Supreme Court (as of April 2012), medical providers are preparing for the eventual wave of an additional 30 million insured patients, in addition to the demographic wave of an aging population which uses more medical services. This is causing a wave of consolidation and roll-up activity to create economies of scale in health care delivery.

Second, faced with ever-increasing regulations, operating costs and liability exposure to the tort bar, individual physician practices are rapidly being absorbed by large hospital chains. The physicians sell their practices and become contracted providers to the large providers require satellite facilities typically built on medical campuses near existing large hospitals which allow the grouping of specialties in one location.

To replace the lost neighborhood locations, the health-care providers are opening critical care centers (often on retail center outparcels) and satellite specialized facilities such as kidney dialysis centers. This moves patients out of high-cost emergency rooms to more manageable facilities.

In accordance with the growth trends discussed earlier, downtown office markets are out-performing suburban locations. Demand is steady and pricing power for rents is enhanced by limited supply and high barriers to entry. Fully developed downtowns require demolition of existing structures to build new ones, an expensive proposition.

However, no two downtowns are alike, and you can't change a ghost town with one building. Look for downtowns with beautification projects underway or on the drawing board. Theater restoration projects, coffee shops, art galleries or farmer's markets are good indications of a rising downtown area.

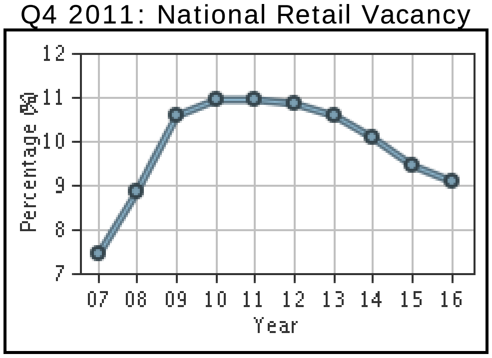
Office supply remains constrained. There are high barriers to entry in many markets but if the economy improves markedly in the second half of 2013 expect to see rising supply in the pipeline.

Over 72% of U.S. office buildings were constructed prior to 1990. Functional obsolescence and a drive for energy efficiency will drive demand for new facilities and the redevelopment of existing buildings. The opportunity to acquire and improve is tremendous. Watch for the emergence of Green funds, Smart Growth Funds, Urban Renewal Funds and Energy Conversion Funds as investors seek opportunities with tax breaks, incentives and upside potential. This is a trend that will start slowly and gather steam over the next five to ten years.

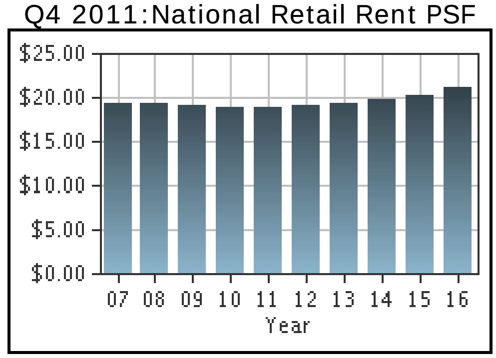
In addition to the positive incentives for the redevelopment of office buildings, expect to see major penalties emerge to force energy efficiency standards on existing buildings. There are around 8,000 EPA Energy Star buildings today, less than 1% of existing stocks, and the now voluntary designation will grow to a requirement. The standards will be equivalent to the CAFE gas mileage requirements for the auto industry. In the next five to ten years expect that a building cannot be sold or financed unless it is "energy-compliant", or funds escrowed for energy-efficient conversions. Value premiums will be given to green buildings, driven by tenant demand for green standards which reduce operating space costs.

Retail:
I still consider retail as schizophrenic I am eager to get back into the sector, but still waiting for signs of anything but a flat future.. The stats have deteriorated further from last year.

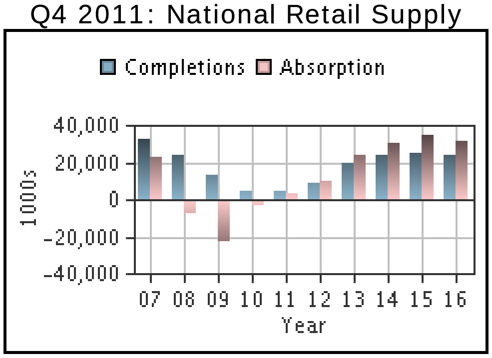
Q4 2011: National Retail Vacancy



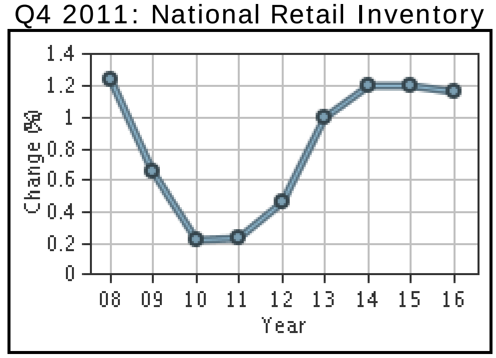
Q4 2011:National Retail Rent PSF



Q4 2011: National Retail Supply



Q4 2011: National Retail Inventory



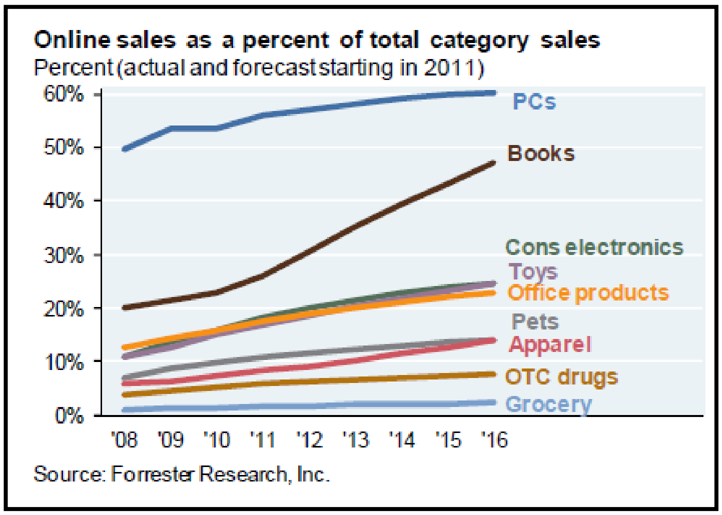
Source: www.Reis.com

While most property types have demonstrated some degree of pricing recovery to date, retail has been a noted exception. During the fourth quarter of 2011, the CCRSI Retail index returned its lowest value since 2003. Retail fundamentals remain soft despite an improving economy and retail sales volume that has already eclipsed the peak rate of the last cycle. Certain segments of the retail universe, including power centers and super regional malls, have notched occupancy gains over the past year, which could presage an impending turnaround in retail pricing.

Also hampering recovery in valuations and fundamentals is the continuance of high lease rollovers among inline tenants. Typically these tenants sign leases with a five-year primary term. Many projects developed at the height of the boom 2006-2008, just prior to the recession, started expiring last year and will peak this year.

These leases contained rental rates at the top of the market, over $20-$30 per square foot (per year). The standard tactic for the tenants who wish to remain (as opposed to the 5,000+ net store closings for 2011) is to decline to exercise a renewal option which typically contains a rent escalator calculated from the base year negotiated at the peak of the boom. Instead they open negotiations for a new lease, or to re-trade the renewal option, at a lower rate and often a shorter term. The tenant volatility is depressing valuations by increasing cap rates 150-250 basis points for purchase offers. This will continue well into 2013.

The other big risk to retail is structural changes forced by the internet. The decline of the big-box is being driven by online sales increases.



"Showrooming", in which the consumer checks out the physical product in the store, and then uses a smart phone to shop for the best price online, is a trend that is not going away. 37% of smartphone users have purchased online.

Some tenants previously considered bulletproof (Best Buy, Barnes & Noble, Staples, etc.) are in the bull's eye of the phenomena. The adjacent chart illustrates the projected shift of online sales as a percent of category sales.

The risk: such tenants lose ground to online competitors, and/or become less space-intensive due to their own rising internet sales. **On the other hand, the centers' largest anchors by far** are grocery chains (Kroger, Ahold and Safeway), heavily discounted apparel (TJ Maxx), and other large discounters (Walmart, Kmart, Kohls, Dollar Tree and Big Lots). As shown, these categories exhibit considerably less sensitivity to internet cannibalization on volume and pricing.

Conversely to the office sector, Retail is more sensitive to income than job growth. When high unemployment levels and flat wage growth are factored into local demographics the near-term outlook for retail in most markets is flat at best. Further, increased consumer spending is mutually exclusive with flat income growth and increased savings rate (from 0.5% to 5.5%, 2001–2010). As consumers and households continue to deleverage, less money is available for discretionary spending.

Many of the retailer reps, brokers and developers I have worked with over the years have successfully adapted with re-use of existing properties such as closed video stores on good corners; acquisition of strong grocery-anchored neighborhood strip centers; and redevelopment of existing centers where critical mass is already in place. Consider that an empty 40,000 big box can be torn down to free up 200 parking spaces originally built at a 5:1 ratio per thousand square feet. At an average size of 300 square feet per space and associated travelways, that's a 60,000 square foot (1.4 acres) outparcel for a new free-standing retail tenant, also the property type most in demand.

In fact the brightest spot in the sector continues to be credit-tenant net-leased retail properties. Known as net-lease, or the acronym NNN, the type is attractive for several reasons. Tenants are generally national companies with excellent credit ratings, long-term leases, and the tenant is responsible for maintenance, taxes and insurance, hence no management responsibilities to the owner.

Transaction volume in this segment is strong and valuations have remained steady from 2010 levels. Cap rates for Class A assets have risen only about 1 to 1.5 percentage points off the 2007 peak of 6% [as prices rise the cap rate falls]. Today new Walgreen's properties (the gold standard of the net lease sector) have asking caps of 7%–7.5%, lower on the west coast and major metros.

Single-tenant broker specialists I know in the sector tell me the biggest buyers are mega-funds that are rolling up hundreds of properties in multi-billion dollar portfolios to be held in syndicated and REIT structures which pool finds from individual investors. This brings us back to a topic we visited at the end of Part 1.

Investment Strategies

Across all property types there are three overarching themes which align investor strategies with the trending economic, demographic and lifestyle patterns. These are:

- **Opportunistic investment**: typically distressed asset acquisition combined with a redevelopment or improvement plan yields the highest upside in the shortest term, and carries the highest risk. This is not for inexperienced or highly leveraged players. It takes deep pockets, great networking in the market for tenant contacts and excellent execution.

- **Value-add investment: a** value-add investment is typically not a distressed asset, and as such a lower risk level than the opportunistic play. Value-add strategy capitalizes on the trends toward energy-efficiency, smaller spaces and population shifts to improve and reposition existing assets.

- **Momentum investment:** this is the safest strategy, and relies heavily on extensive and detailed market research. The objective is to identify markets with strong growth fundamentals, seek out Class B or high C properties, make aesthetic improvements and implement efficient management tools to increase occupancy and raise rents, using the forward momentum of the market fundamentals to increase NOI. Increased value occurs from natural NOI increases and the lowering of valuation cap rates from stabilization and elimination of deferred maintenance.

These are the strategies best-suited for the economic climate, and meet the requirements of the capital markets for both debt and equity.

The Era of Equity: the Key to Creating Permanent Wealth

I've saved the most important topic for last. If you're still reading, this is your reward for sticking with me.

I know from the email I get that there are sub-sets of readers who want to own income-producing real estate, but not necessarily as direct owners. There are those who have careers in other fields and plan to continue, but would like to build income-producing investments for retirement or to supplement their income. You are potential passive investor. There are also investors who own several single-family houses or small apartment projects. You want to move up to larger assets, but are hampered by a lack of funding or knowledge. Last, there are those who find themselves in similar position to me. I'm 56, a successful investor for many years, and looking to retirement and a time when I won't be chasing deals.

Direct Ownership is not for everyone

Direct ownership is not something you do once and forget about. The responsibilities are ongoing for as long as you own the asset. Few people talk or write about the demands of the profession on an everyday basis.

The purchase of income-producing real estate requires significant due diligence of the market, and the potential investment property. Due diligence is expensive, time-consuming, and there is no guarantee the money or time spent will result in closing an acquisition. If the investor is inexperienced, incomplete inspections or improperly performed due diligence can result in a disaster if the deal does close. Passive and move-up investors are at a significant disadvantage in performing adequate due diligence for a smart acquisition.

Management of the asset is required. If the investor lacks size or scale, the options are for self-management, or hire fee managers. Most fee management companies have a number of properties under management and the investor must manage the manager to insure the asset is properly run. For passive investors this is a hurdle often hard to overcome. Move-up investors are accustomed to running their own property and more likely to be successful with one or two properties until sufficient scale can be built up to afford a captive management team.

Financing is typically required to complete commercial real estate acquisitions. Multiple banking relationships and a contact network of mortgage sources are necessary to efficiently leverage the equity capital for optimum returns. Individual investors are required to sign personal guarantees for bank loans, with ongoing requirements for financial reporting to the lender. This barrier is often a “wall” that small investors cannot climb, and passive investors do not want the risk exposure.

There are several alternatives to direct ownership of commercial real estate. Each structure has advantages and drawbacks. An overview of the most common structures:

> **REIT's (Real Estate Investment Trust)** are tax-advantaged at the entity level. As long as they pay out 90% of their income to the shareholders there is no tax at the entity level. Shareholders are issued a 1099 at year-end, and can be liable for unrealized capital gains. This is one of several reasons many trade below their NAV (Net Asset Value). Public REIT shares are traded on the stock exchanges and highly liquid. There are also a number of privately traded REIT's which are less liquid, but often have lower costs. The tax status of private REIT's is the same as public funds.

REITs typically specialize in one property type. Those that have broader portfolios often split the funds into separate operating units.

MLP's (Master Limited Partnership) are relatively few in number, with about 100 publically traded entities in operation. This structure is mostly used for pipeline and energy production properties. There are about a half-dozen real estate MLP's as income producing real estate is one of a very narrow list of properties the structure is allowed to hold. MLP's are pass-through entities taxed as partnerships, generally with a corporate general partner who is compensated for its services prior to distribution of profits, losses and gains. Partnership interests are issued a K-1 for tax reporting, but tax effects are unknown until the K-1 arrives. Fees are generally high, and shadow gains can be an issue. Public MLP's have liquidity, but often limited by lock-up provisions of a certain time frame. MLP's have access to large capital providers who can make a market for ownership interests. (The largest of the real estate MLP's, WP Carey Company, recently announced it is converting to a REIT structure.)

The LLC (Limited Liability Company) is the most common entity structure for direct ownership, syndicated funds, and private equity vehicles. An LLC is a pass-through entity treated as a partnership with no tax liability at the entity level. LLC's may produce passive losses, also subject to the investor's tax status. They may be managed by a corporate-entity manager, with similar fees and compensation as an MLP. Members are issued K-1's for tax reporting and it is common to have net cash distributions with negative taxable income, also known as passive losses. An additional tax benefit is a minority discount on valuation for estate planning purposes. There is a disadvantage in that interests are generally illiquid, and to sell a membership interest the investor is typically required to offer the interest first to the other members.

In the private equity markets, a record 450 closed-end funds are seeking to raise $165 billion, according to Preqin, which tracks alternative investments. This is a huge jump from last year, when 114 real-estate funds closed on $44.4 billion. The marquee private equity fund names are all deploying huge amounts of capital to major acquisitions, including Blackstone's group of funds, Vornado Realty Trust and Equity Residential Trust.

These funds typically have very high minimum investment criteria, usually $1 million and greater, which locks out the small investor. The mega-funds are like large ships in that they cannot maneuver in smaller properties (e.g. <$5 million) or in markets outside the major metros.

There is ample evidence that income-producing real estate is *the* rising asset class, and the reason I bring up the subject in a forecast. **I believe that real estate is the best asset available for investors to receive ongoing stable income, protection of principal, and control of your own destiny.** If you are interested in building wealth to be in charge of your future, the time to act is now.

As we've seen, opportunities abound in many secondary and tertiary markets that large funds can't touch. This has traditionally been the stronghold of large direct investors and developers who make fast decisions and have the capital required to act.

This gap opens the door for a smaller, more nimble investment vehicle that can utilize the legal structure of the large funds, but retain the ability to maneuver of direct investors.

This is the source of the opportunities in private capital markets mentioned earlier.

Syndication 2.0

A better method of breaking into income-producing real estate investment for passive and small investors is to align with a more experienced and better funded partner or ownership group. This gives rise to the modern syndication investment vehicle. Syndications were a popular investment vehicle typically structured as limited partnerships in the 1980's, but changes in the tax law and securities regulations made the old structures inefficient and obsolete.

Real estate syndication is the pooling of money from numerous investors and investing the capital pool into income-producing real estate. The investment can be leveraged with a mortgage loan secured by the property to fund the purchase. The benefits of investing in a real estate syndication is that a person can own a percentage in the real estate asset without having to be involved in the day-to-day management of the project.

These funds have become popular and many experienced investors are using them to raise acquisition capital. The investor's capital is invested in a specific asset and the performance of the asset is known to the entire fund. The organizer of the syndicate is known as the sponsor or manager.

There are three key points investors must investigate prior to investing in any fund.

- **The sponsor** is critical to the success of the investment. The sponsor's track record, financial stability and expertise of the principals are paramount to the investor's success
- **Transparency** is a major criterion for every fund. The financial reporting must be clear, regular and accurate. The financial results directly affect the investor's returns and tax liability and the only way to avoid surprises is with good data
- **Compensation** of the sponsor should be in alignment with the interests of the investors

Property and market due diligence are replaced with syndicator due diligence. No one should invest in a syndicated investment without thorough investigation of the principals. For personal reasons (detailed further in a moment) I have been researching syndication sponsors and funds for the last year and a half.

The best of the funds have several common traits. The business model is focused on one property type, building a critical mass of properties in each market chosen, and has access to sufficient deal flow to scale operations at will. A high-grade fund is well-capitalized, with superior operational expertise, and management incentives are aligned with the investors' interests.

After extensive study I am now associated with a sponsor that meets all of these criteria, **37th Parallel Properties** based in Richmond VA. They specialize in multi-family properties, seek out markets based on a proprietary evaluation model which incorporates 17 metrics, with a management team deep in real estate asset management. The business model is based on the Momentum Investment strategy mentioned earlier, highly repeatable and of sufficient scale—about $100 million in Assets under Management (AUM)—to provide geographic and market diversity.

There is one more attribute that 37th Parallel offers that is unique; the combination of an investment vehicle and education. In short, they teach their model to investors like me who desire to develop a similar strategy.

Investment + Education = Permanent Wealth

37th Parallel offers an education program that in my view is the most comprehensive program I have ever seen. In full disclosure, I am also associated with their **Multi-Family Partner Program** **(MPP)**, a truly unique education opportunity for all types of investors**.**

The group first came to my attention in late 2010 by ordering multiple copies of my book, *Dealmaker's Guide to Commercial Real Estate* as the base text for the MPP program. After talking at length with Chad Doty, CEO I became interested in learning more for several reasons; as a real estate investor looking for alternatives to direct ownership and as an author and speaker interested in providing education to the hundreds of investors I've interacted with online and in seminars since 1998.

I spent over nine months performing due diligence on the company, the principals and their portfolio. I met many of their investors at their annual conference, which I might mention is a stark contrast to most funds which discourage any contact between their investors.

In the process Chad and I began talking about an alliance that would allow me to join with their education team to provide mentoring and coaching services. The program delivers support from a dedicated team of professionals who do what I do on a daily basis.

This is the best solution I have found for first-time investors, passive or active, and move-up investors to grow investment capital while learning how to do what direct investors and syndicators do, within the safety net of a proven investment model, and with direct guidance and instruction from real estate professionals.

If this sounds like something that appeals to you as an investor, I encourage you to visit the **MPP website**, fill out the form and get a detailed information kit with no cost or obligation.

Grumpy Old Men need help too

I mentioned I had personal reasons for investigating syndicated funds. This is a very appealing model for "seasoned" commercial property investors like me. I am a lifelong real estate investor beginning to think about retirement. I've built up an eight-figure direct-ownership portfolio over many years, and now that the time is near to start realizing gains, the available exit strategies are less palatable than they used to be.

The list of options is short:

- Cash sale
- 1031 tax-deferred exchange to STNL properties
- Tenant-in-Common investments
- Syndicated real estate investment funds

This is a demographic cohort I refer to as the **Grumpy Old Men (GOM)**. I've got three brothers who are also my partners that also qualify as GOM. As charter members, I've suggested we adopt a slogan: **"We're old, we're rich, and we're pissed."**

The market is in such turmoil, and the tax code in such chaos, that **selling for cash** is not appealing. Many of our assets have been owned for many years, and their tax basis is very low relative to market value. Market value is another issue. As we have seen, buying opportunities are the best in a generation, but I do not want to sell into a buyer's market. Thus for me, any strategy that involves selling the property must have a three- to five-year time horizon to allow the capture of built-up unrealized capital gains.

Tax-deferred 1031 exchanges are an option, but handicapped by the same valuation issues as above. To reduce management responsibilities I would gravitate toward single-tenant net-lease (STNL) properties leased by credit-grade tenants. STNL is a very popular sector, but demand for the property type drives returns down to single digits. Tax-free liquidity can be achieved from post-exchange refinancing, but only on an 80%-85% LTV ratio, which does not allow a complete cash-out.

Tenant-in-Common (TIC) interests eliminate management responsibilities and requirements for personal guarantees, but at the expense of total loss of control, no liquidity, and no recourse against the promoter as would be provided in an LLC Operating Agreement. The tax treatment of the interest can be questionable if the promoter has not structured the proper documentation to meet both IRS real estate guidelines and SEC securities regulations. The convoluted ownership structure assures zero liquidity and no minority discount for estate-planning purposes. In short, a TIC has all the bad elements of passive real estate investment and none of the advantages.

Personally, this left syndication as the most advantageous strategy for me to pursue. In searching for answers to my own desire to position myself for the future, I am happy to share the results of my work with the significant number of investors in similar situations.

Currently about 90% of my net worth is in direct-ownership of commercial real estate. I hold very few passive investments such as stocks or bonds. I'm a "dirt" guy, and stick with what I know. Over the next five years we plan to shift about 50% of our portfolio assets into syndicated funds similar to the 37th Parallel model. For the first time in my career I am ready to take my hands off the wheel and let someone else drive. The alternative is to show up every day and keep doing what I'm doing.

I did syndications in the 1980's, but as mentioned those structures no longer work in today's environment. The LLC structure allows real estate professionals accustomed to tax benefits of direct ownership to shift from managing their own properties to a more passive investment model, without giving up the tax advantages. **Most importantly, the investment model will allow me to take advantage of the trends detailed in this forecast.**

This structure retains all the benefits of direct ownership I rely on—stable income; value appreciation; equity growth; and tax benefits—with none of the downsides of property management, asset management, personally-guaranteed loans and constant risk exposure. In addition I will gain geographical diversity (without spending half my time traveling), and can change property types as easily as the market changes.

Best of all, my investment is in the one asset class that I truly know well enough to be an expert. That gives me a great amount of comfort in knowing that I am not at the mercy of a stockbroker or hedge-fund manager who may have a bad year, or suddenly realize everything in his fund is 100% correlated to the S&P. I can review the statements from a real estate investment and spot red flags in an instant.

So for the seasoned Grumpy Old Men out there (women are welcome too, but I would never call you "old", much less "grumpy"!), consider learning more about the **Multi-Family Partner Program** and how syndication can be a viable alternative for you as well.

Summary

I made a bold prediction in last year's forecast:

> **"2011 will be considered the foundation year for a new era of wealth-creation in commercial real estate."**

The numbers and statistics we have just examined proved the call.

I believe the coming year will be the last opportunity to acquire properties at discount valuations. I'm hearing and seeing anecdotal evidence that valuations are approaching replacement cost, which is the marker for the feasibility for new development. With the exception of retail

Times like these are rife with the pitfalls of unfocused strategies. I've written elsewhere about the importance of having a predetermined plan to guide investment decisions. This is the only way to distinguish clunker deals from true opportunities.

I hope this report has been enlightening, and will be helpful in planning your investment course. I wish you the best in reaching your goals.

With best regards,

Ray Alcorn

April 2012

Disclaimer: Nothing contained herein is a solicitation to invest in securities or to buy or sell any investment. Past performance does not guarantee future results. Please consult your financial and legal advisors before making any investment.

Resources

It is beyond the scope of this forecast to offer implementation strategies for real estate investments. As a shameless plug, I have several products available which cover the subject matter of commercial real estate investing in detail.

My books and materials supply detailed information and guides to personal investment planning, performing market analysis and due diligence, specific deal structures and strategies, as well as templates for the preparation of personal financial statements, loan proposals and business plans.

The products available include:

DealMaker's Guide to Commercial Real Estate

DealMaker's Guide Video Seminar & Workbook: Getting Started in Commercial Real Estate

DealMaker's Guide to Mobile Home Parks

CTRL + Click on the titles to follow the link for complete descriptions of each product, with sample chapters and video clips. All are available at **DealmakersGuide.com** with several new products coming in 2012. Be sure to sign up for the mailing list.

About the author...

Ray Alcorn is CEO and a principal of **Park Real Estate Inc.,** a commercial real estate development and investment firm based in Blacksburg, Virginia. The company owns and manages a portfolio of retail, office, and hospitality properties.

Ray has been in the commercial real estate industry for over 30 years. He hosts the Commercial Real Estate Discussion Forum at **CREOnline.com**, where he answers questions and participates in discussions with investors from across the US and the world.

In his home study course, **DealMaker's Guide to Commercial Real Estate** he shares a lifetime of experience investing in commercial real estate. This book provides real-world information written by a true dealmaker, including how to design your personal investment criteria to fit your overall life goals. It is an invaluable resource for creating and building wealth in commercial properties of all types.