

CB RICHARD ELLIS

## SPECIAL REPORT

# Advantages of Investing in Commercial Real Estate



**CBRE**  
CB RICHARD ELLIS

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## INTRODUCTION

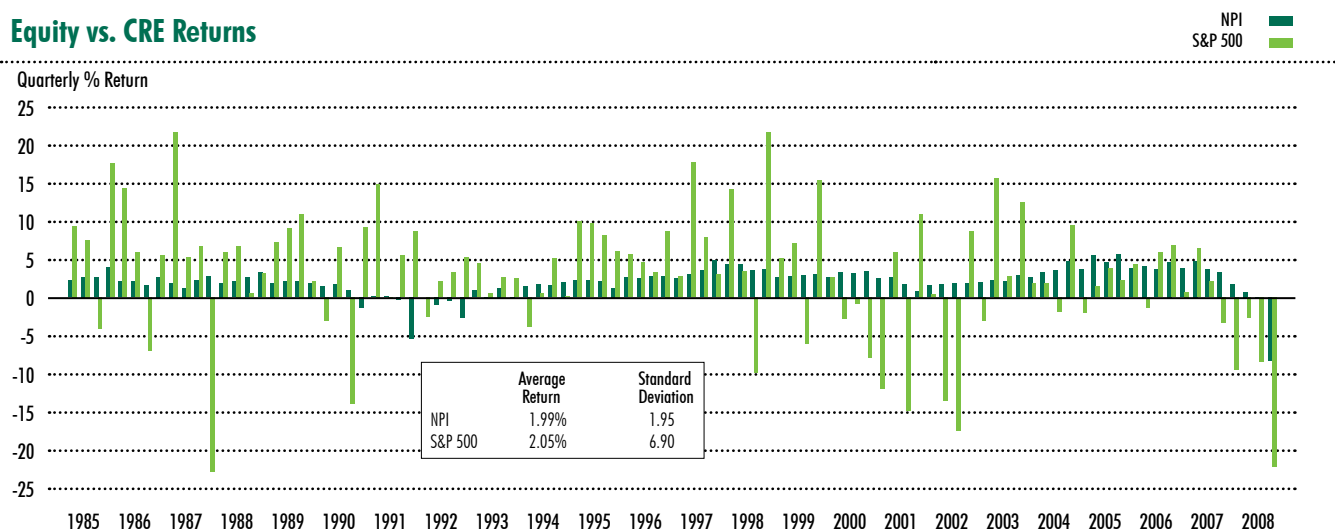
The economic climate of late has battered investment classes across the board, including commercial real estate. Aside from the usual arguments about including real estate in a well-diversified portfolio, there are compelling reasons to invest in commercial real estate (CRE) in the current environment. Though the risks are real, the income and return characteristics of CRE investments provide a buffer through annuitized cash flow, and savvy investors who “dollar cost average” into the real estate cycle may be able to acquire assets at prices that will deliver attractive returns over the long term.

## RETURN CHARACTERISTICS OF EQUITY VS. CRE

One of the key characteristics that CRE offers in any market environment is stability. Fixed lease terms over long periods of time combined with long lead times needed for new competitive supply generate fairly stable income streams. Combine the stability of income with an appraisal process that is somewhat backward-looking in calculation methodology, and values will typically not move too sharply in any one period.

This stability is illustrated in the following graph, which highlights the CRE total returns versus those of the S&P 500 since 1985. The CRE returns are nearly the same over the long term as those of stocks, with an average total return of 1.99% since 1985 Q1 versus 2.05% for stocks. The returns generated with stocks are highly volatile, however. The standard deviation of returns for the S&P 500 is 3.5 times that of CRE.

### Equity vs. CRE Returns

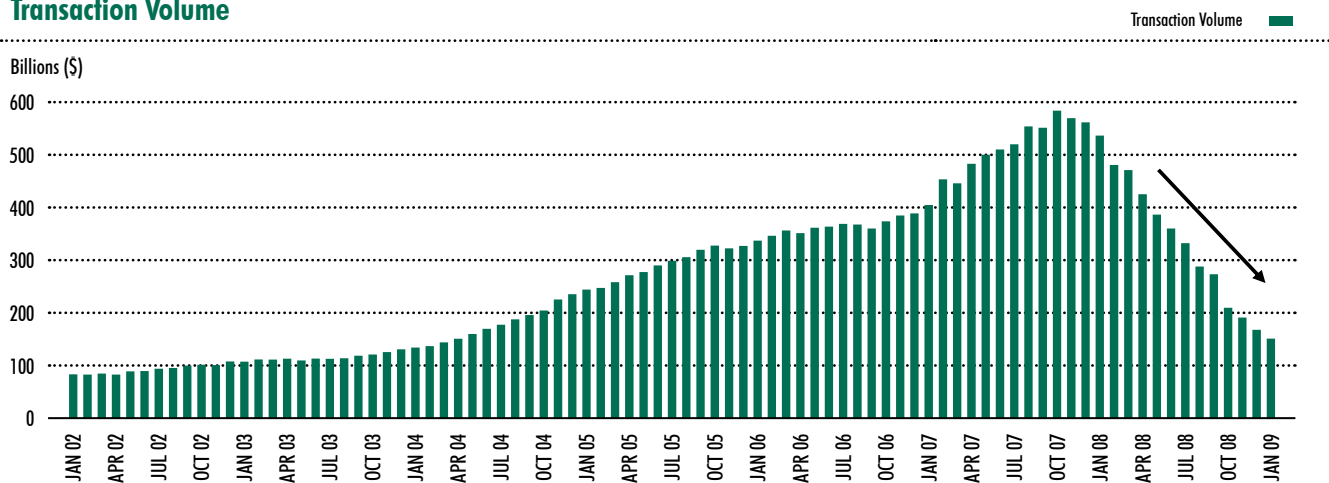


Sources: CBRE Econometric Advisors, NCREIF, S&P 500

Granted, one can argue that stocks are a more liquid asset class; however, this advantage on liquidity is not so clear cut. One could sell real estate at some price in any market—the question always becomes how much of a discount one is willing to take. An investor could sell his or her interest in a CRE fund even in the current market, yet in doing so would generate losses far greater than those seen in the NCREIF index into the fourth quarter. Moreover, the volatility around investments with such an exit strategy would be far greater than that of CRE overall. Developing an orderly, planned strategy around the exit of an investment is key for a CRE investor.

PERCEIVED RISK: BID-ASK SPREAD HAMPERS PRICING

Transaction Volume



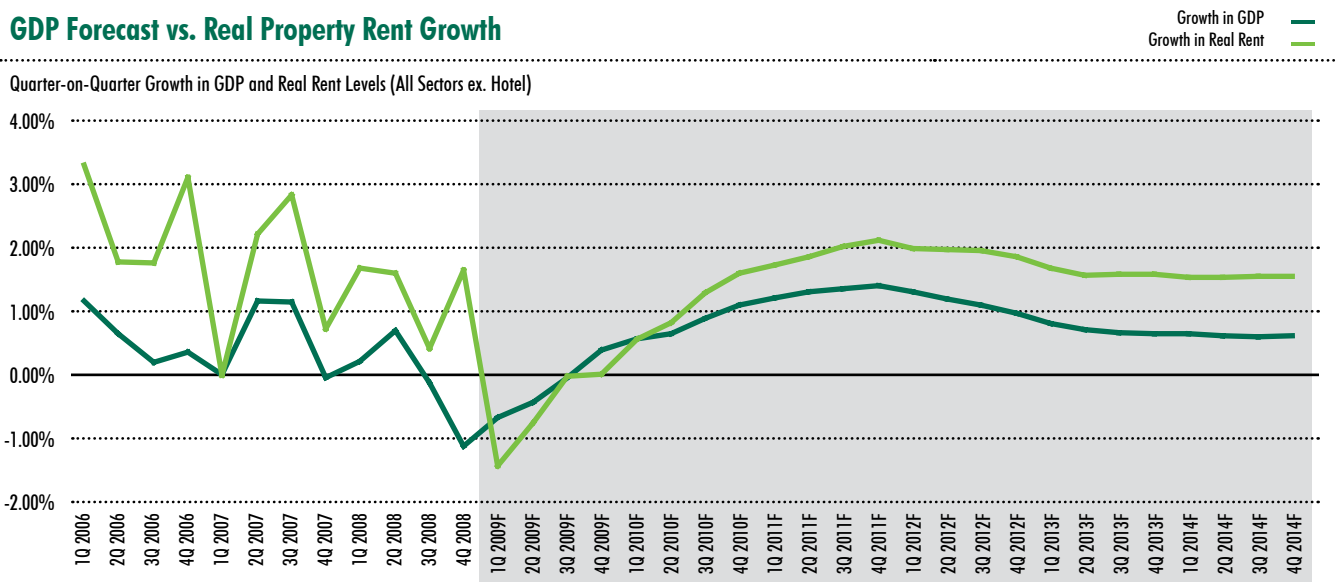
Source: Real Capital Analytics

A key difficulty in developing and implementing an exit strategy in the current CRE environment is the wide chasm between the [bid-ask spread](#). A contributing factor to this is the relatively high appraisal values prevailing in the U.S., causing sellers to dig in their heels unless they are truly distressed. At the same time, buyers are looking for bargain-basement opportunities. As a result, transaction volume has plummeted 74% in the U.S., according to Real Capital Analytics. In the U.K., where appraisers have been more aggressive about marking down values, transaction volume has been slightly higher. However, with the NCREIF Core Index reporting a -8.3% quarterly return for the fourth quarter, we anticipate that appraisal write-downs in the U.S. will be prevalent in 2009, and the long-awaited market clearing prices will start appearing as a result.

**PERCEIVED RISK: GETTING IN TOO EARLY AS REAL ESTATE CYCLE LAGS BROADER MACRO RECOVERY**

Another risk we see in CRE is its lagging recovery to the broader economy, as exemplified by its trailing performance to yearly GDP growth as indicated in the chart below.

**GDP Forecast vs. Real Property Rent Growth**



Source: CBRE Econometric Advisors

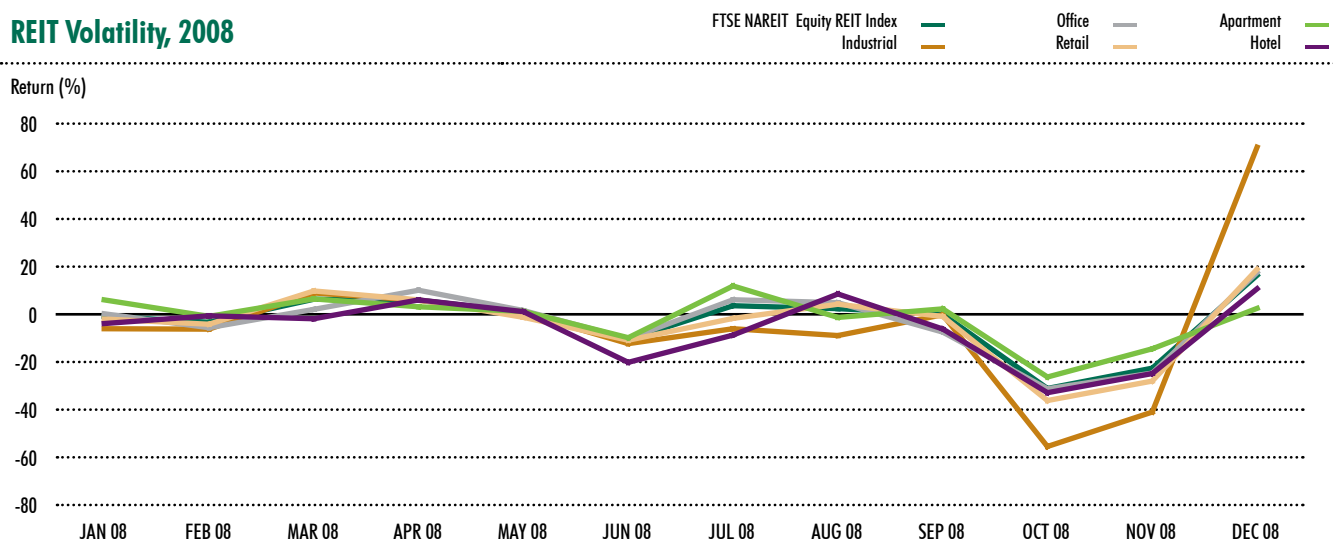
It takes real rent growth in the Torto Wheaton Rent Index approximately an additional two quarters to begin its ascent, as compared to the forecasted GDP recovery. This means that for real estate investors looking to time the cycle, patience is key, since macro indicators will turn positive ahead of fundamentals, and the CRE recovery will be more prolonged than that of the overall economy.

**PERCEIVED RISK: REIT VOLATILITY**

Another challenge CRE investors face today is what to make of the volatility in the REIT market and its implications for private market valuations. One argument is that the volatility REITs have seen in their valuations come not from the underlying fundamentals but rather from discounts stemming from debt concerns. The tight trend around the performance of REITs began to fall apart after May 2008, and individual property type REITs began to distinguish themselves. This allows us to dissect how quickly REIT investors react to changes in the economy that they often believe, rightly or wrongly, will instantly impact REIT property sector valuations.

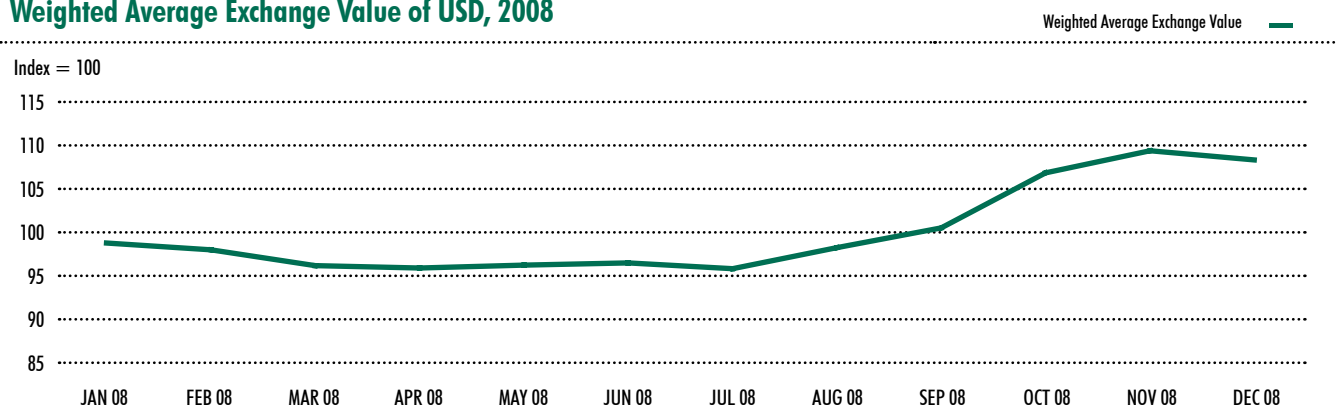
The volatile performance of industrial REITs, for example, has been highly correlated with the performance of the dollar: As the U.S. currency appreciated and our trading position relative to the rest of the world improved, investors became instantly bullish on industrial REITs in the fourth quarter of 2008. While this would fleetingly affect the position of large REITs such as Prologis and AMB in the global logistics business, such a currency bet was short-lived as the rest of the world plunged into recession and U.S. trading partners were no longer in a position to buy our goods. This is a poignant example of how listed markets can overreact with regard to how quickly market forces will impact NOI and, subsequently, valuations in the private markets, and why, for the long-term investor, short-term volatility in the listed real estate markets has to be discounted.

## REIT Volatility, 2008



Source: NAREIT

## Weighted Average Exchange Value of USD, 2008



Source: Economy.com

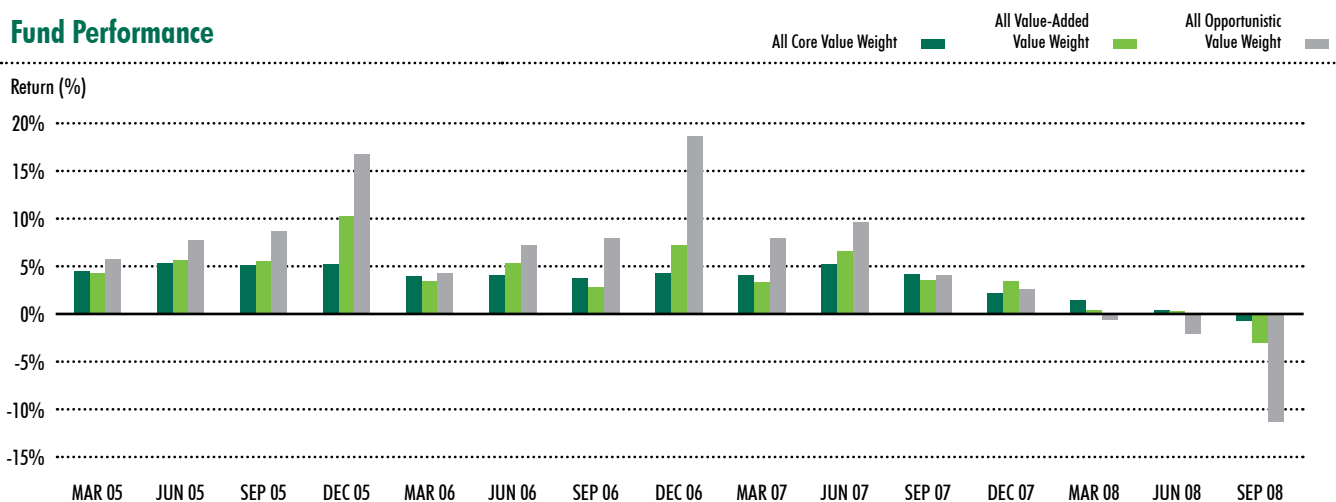
### ADVANTAGE: INFLATION RISK

With the economy struggling to find its bottom and the unemployment rate rising, the Federal government has made the decision to temper the pain of the recession with increased spending. With billions of dollars injected into the financial system, the issue of inflation naturally comes up, in the “too much money chasing too few goods” form. Currently, the bottleneck from an immediate inflation meltdown lies in the speed with which money gets into consumers’ hands and is spent, a measure economists call the “velocity of money.” This metric is at its lowest level since 1991, because banks are not lending—yet. Typically there is a lag time of a few quarters for the transmission of spending to make its way into consumers’ wallets. If there is not enough demand for these dollars at that time, both here and abroad, then the effect of inflation will erode returns of stocks, bonds and commodities. CRE will be sheltered from this potential storm as leases are locked in over long time periods and real estate assets have longer holding periods than other asset classes, which would insulate returns from the destructive influence of inflation.

## ADVANTAGE: NOT ALL FUNDS MOVE THE SAME—THE TOP QUARTILE HISTORICALLY OUTPERFORMS

The economy has been in a downturn since early 2008, and real estate returns are exhibiting pain across the board. Still, it is a mistake to assume that this pain is distributed evenly. Some strategies and fund types will outperform over different portions of the market cycle. There is pain in the current environment, and there is likely more to come, but many investors will avoid the headline numbers as the brunt of the downturn is being borne by investors who employed highly debt-driven strategies.

### Fund Performance



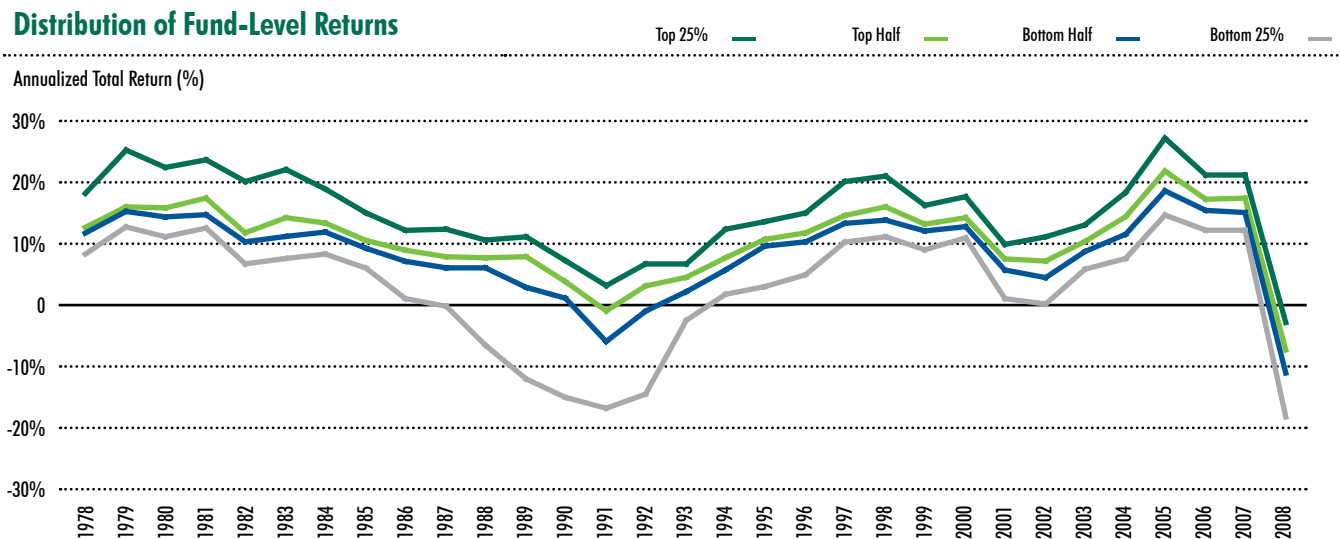
Source: NCREIF Townsend Fund Index

Across fund types, opportunistic funds outpaced both value-add and core funds in terms of returns during the upswing in the market through 2007. Likewise, this relationship is holding into the downturn. The large losses sustained by the opportunistic funds in September 2008, which were due in large part to excessive use of leverage, dragged down the fund index overall. While the returns for core and value strategies also started turning negative in late 2008, these losses remained small in magnitude.

What the averages of the charts above and index averaging in general mask is the wide distribution of returns among various markets, property sub-types and, ultimately, investment funds, with some funds significantly outperforming their peers. As the following analysis shows, in previous downturns some funds have been able to generate returns significantly higher than market averages. The lesson from these previous recessions is that savvy investors will be able to spot lucrative opportunities and weather the storm much more easily than many of their peers.

The following graph of the NCREIF Fund Index Open and Diversified Core Equity (“NFI ODCE”) fund level indices shows that there has been a wide distribution of returns across funds historically, with a stark contrast between the winners and losers. This chart represents all types of real estate investment categories, including different property types with variations on the degree of financial leverage. This variety of class and type does not explain all of the variation in performance. Many real estate investors fared poorly in the late 1980s and early 1990s as some managers who used relaxed underwriting standards with backward-looking expectations failed to adapt to the realities of a market that was awash in new supply. This, combined with the sudden shutdown of traditional lending to the CRE sector, created illiquidity in the marketplace. In the face of such shocks, the sector overall experienced lower returns, but the experience across investments varied dramatically.

## DISTRIBUTION OF FUND-LEVEL RETURNS REFLECTS WINNERS EVEN IN POOR TIMES FOR PROPERTY INVESTMENT



Source: NCREIF ODCE Index, 4Q08

As shown in the preceding chart, in the downturn of the 1990s, the worst-performing real estate funds saw returns some 20% lower than the NFI average, while the best-performing percentile saw total returns some 5% better than average. Better-capitalized managers with more industry contacts, experience and market intelligence were able to weather the worst of the downturn in the late 1980s and early 1990s and were still able to deliver value to their investors.

Likewise, as returns turned downward in the market crash that followed the Internet boom, by mid-year 2002 fund-level returns ranged anywhere from 8% per year for the top-performing funds to annual losses of 2.2% per year for the bottom rung. Amidst the hype of the Internet boom, investments that projected \$100 annual rents in the San Francisco Bay Area were assumed to be a permanent feature of the market, but burned many real estate investors in that market downturn.

Similarly, in the current real estate environment, some funds outperform while others trail. True, returns across all quartiles were negative into the fourth quarter of 2008, but it is still the case that the distribution of returns is uneven. The poorest-performing funds posted losses approaching the worst conditions of the 1990s downturn, while the best-performing funds are experiencing minimal losses like the worst seen following the Internet boom. With a combination of weakened leasing, falling rents and property income, and increasing cap rates, total returns of all property declined in the fourth quarter of 2008. Capital Markets professionals are seeing buyers discounting the future so heavily that they are giving little credence to the possibility of increased cash flow or lease-up in the later years of the asset's life. Such factors are keeping a false ceiling on returns, as fear is giving way to unrealistic assumptions being factored into pricing decisions. This wave of doomsday expectations has caused many sellers to walk away from deals and buyers to simply wait in hopes of a deeper bottom.

## ADVANTAGE: OTHERS SIDELINING AND MISSING OPPORTUNITIES

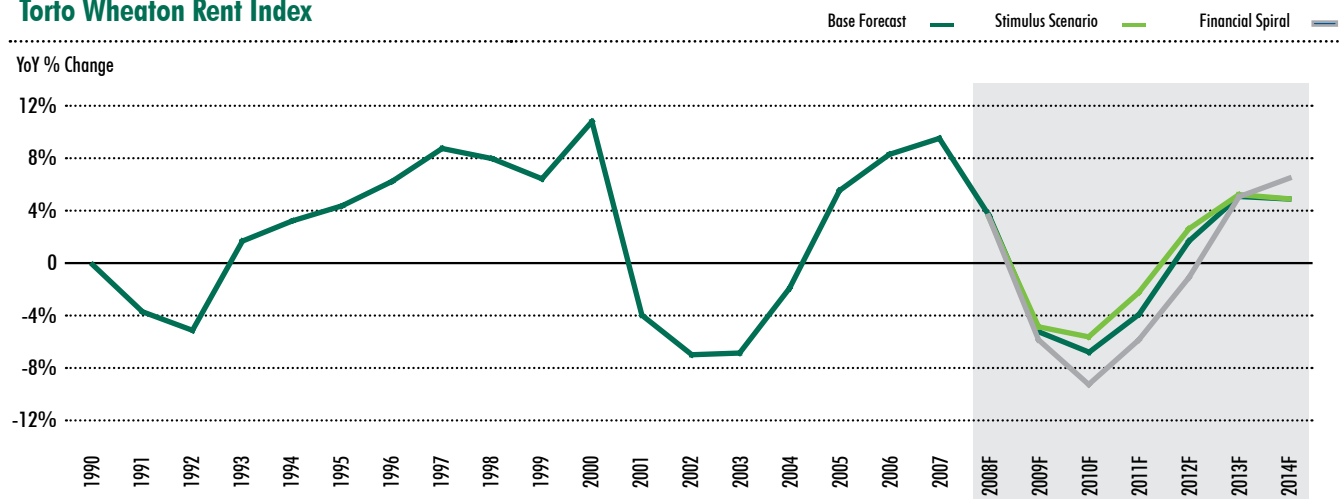
Another characteristic of the CRE market today is that of sidelining—essentially, investors sitting out the market, waiting for someone else to make the first move. TWR forecasts that overall returns will continue to be negative through 2010 in light of an outlook of continued job losses through 2009. A prevailing sentiment is that buyers are paralyzed by indecision and do not want to look foolish in the harsh light of mark-to-market reality. For those willing to acknowledge that they may not time the bottom with absolute precision, such circumstances can present an advantage to the CRE investor who is willing to take action.

Stock market investors often pursue dollar cost averaging strategies, putting the same amount of capital into the market in every period regardless of the current value of stocks. If stock prices seem to be close to the bottom and one makes a significant investment, there is a tremendous downside risk if one has misjudged the market bottom. This approach limits losses on the downside of the market if continued declines are experienced but is also a way to be certain one is active in the market once conditions turn. In regards to CRE, investors would be advised to think of market timing in the same manner.

As shown in the following graph, there is some uncertainty around the timing of TWR’s forecast of market trends, with office rent growth moving back to the positive range somewhere from 2012 to 2013. If the current efforts by the government are successful, rent growth will turn positive sooner on the tail wind of stronger employment growth. Failing that and a longer period of stress, rent growth will not resume until 2013 at the earliest.

Given this range of potential periods for rent growth, for a fund with a five-year acquisition period, it does not make sense to wait until 2013, when rent growth will definitely be in place, before starting the process. In starting the acquisition period earlier, one can avoid the crush of investors that will inevitably jump into the market when there are clear signals of healthy rent growth. Furthermore, if the rent growth does start earlier, potential deals will already be in the pipeline, ready to take advantage of stronger conditions.

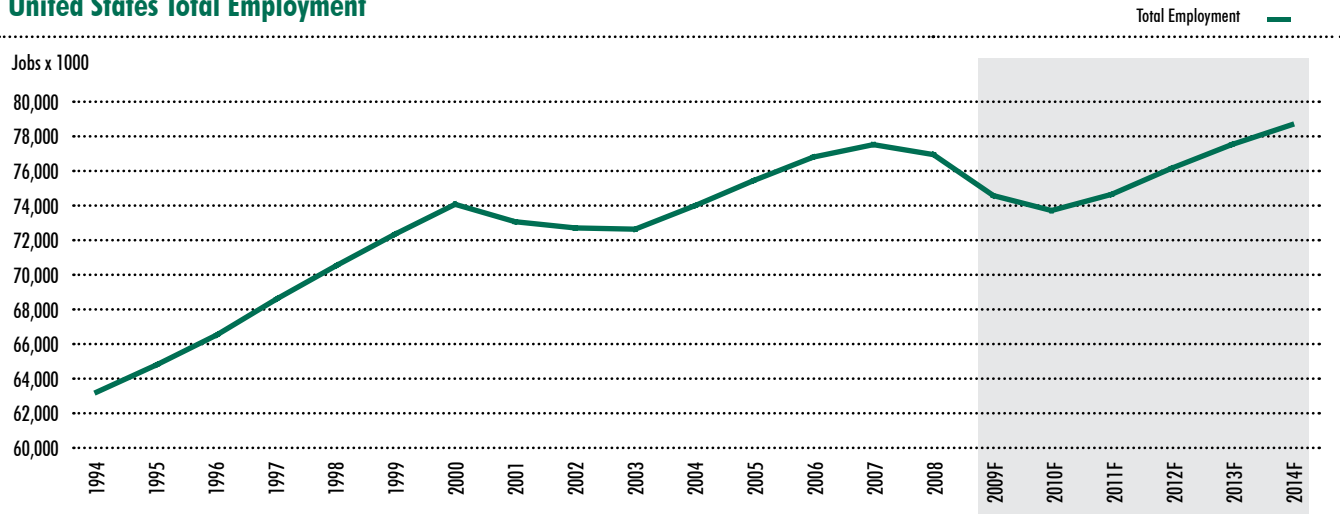
### Torto Wheaton Rent Index



Source: TWR Outlook, Spring 2009

Despite the risks around the timing of the recovery, as the following graph shows, in TWR's base forecast, U.S. employment rebounds rather quickly after 2010. Employment is a lagging indicator, and as the property-specific examination below demonstrates, most sectors are projected to recover within the next two years, demonstrating again the risk of waiting too long to become active in the market.

### United States Total Employment

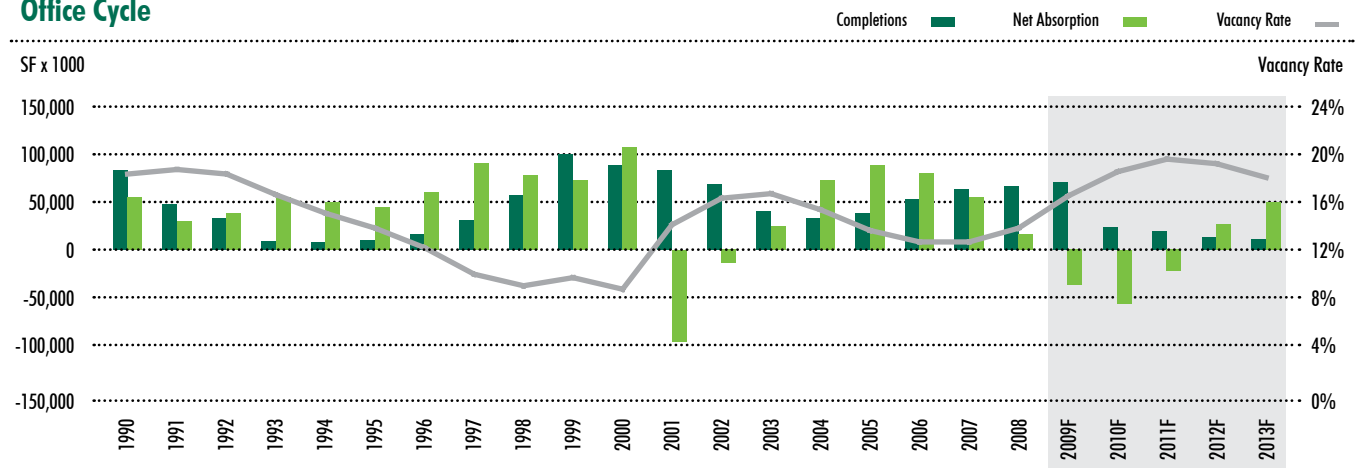


Source: TWR Outlook, Spring 2009

### SECTOR-SPECIFIC OBSERVATIONS

In the office sector, employment begins to recover in tandem with the overall U.S. economy. This recovery will be mainly driven by the services sector, consisting of accountants, lawyers, consultants and others who will be tapped to do the work created by the government's stimulus bill. In the TWR forecast of the office market cycle, vacancy peaks shortly after 2010, and net absorption only takes a year or two to recover.

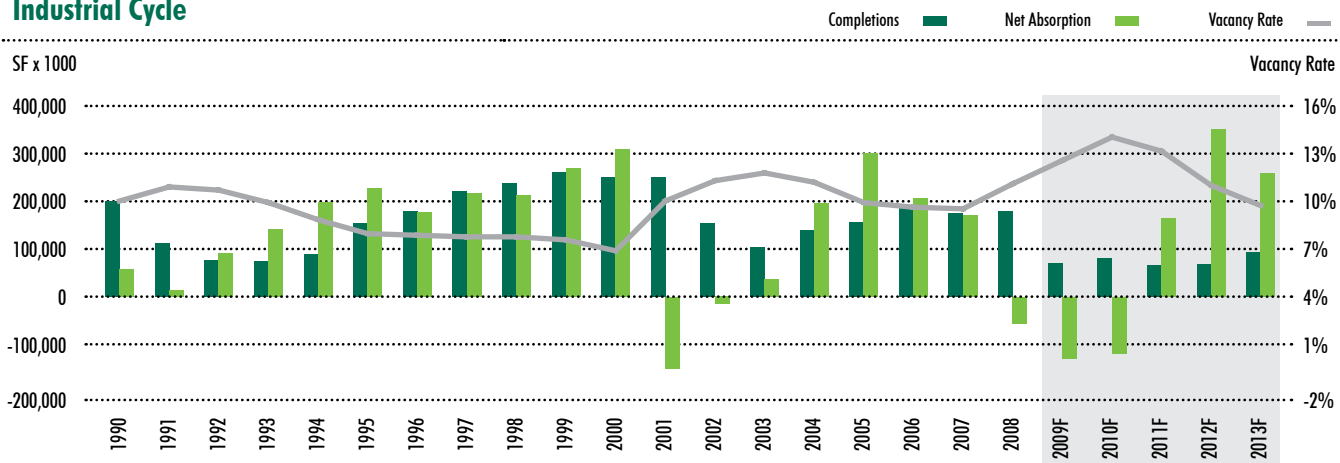
### Office Cycle



Source: TWR Office Outlook, Spring 2009

In the industrial market, we see a similar trend. Vacancy peaks in 2010, then begins a steep descent as net absorption makes a strong recovery in 2011. Manufacturing jobs decline but stabilize; however, distribution is where the growth will be, as global logistics will become an increasingly important part of the industrial business. As space becomes used more efficiently and technology becomes more sophisticated, industrial employment will naturally decline.

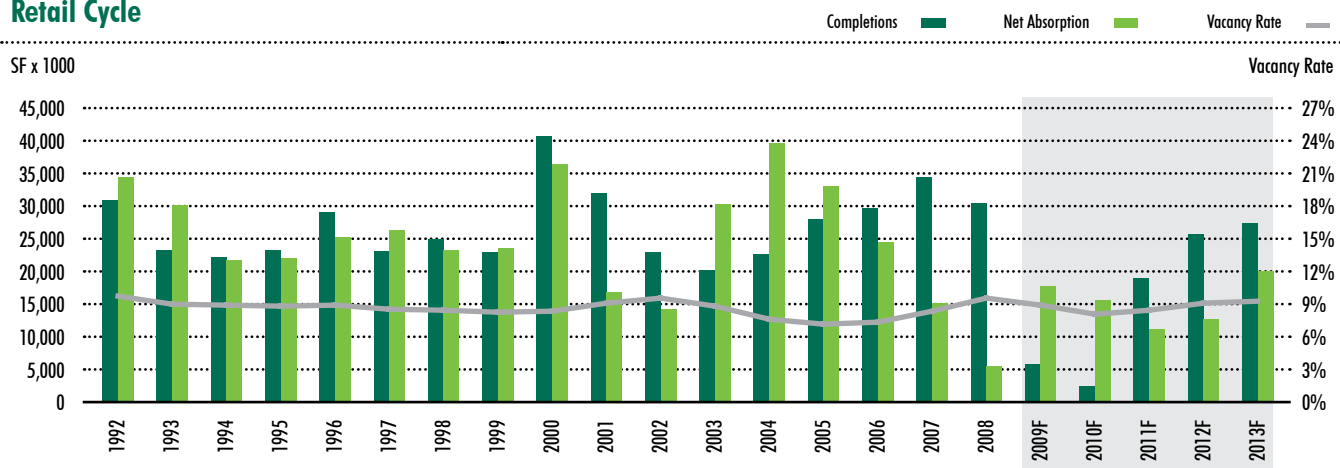
### Industrial Cycle



Source: TWR Industrial Outlook, Spring 2009

Retail is the one asset class that does not follow this trend, as its downturn in the cycle is just beginning. This can be explained partly by the lack of inertia in the retail market. As observed by Capital Markets professionals who specialize in retail, there is great difficulty in getting agreement on the security and strength of cash flows of retail assets. As a result, very few assets have transacted, and the mark-down process has just begun. The Capital Markets team reports that existing retail assets in stable financial condition are concentrating on operating efficiencies and fielding rent concession requests from tenants. In the 2010-2011 timeframe, retail fundamentals will be feeling the lagged effects of today's battered consumer market.

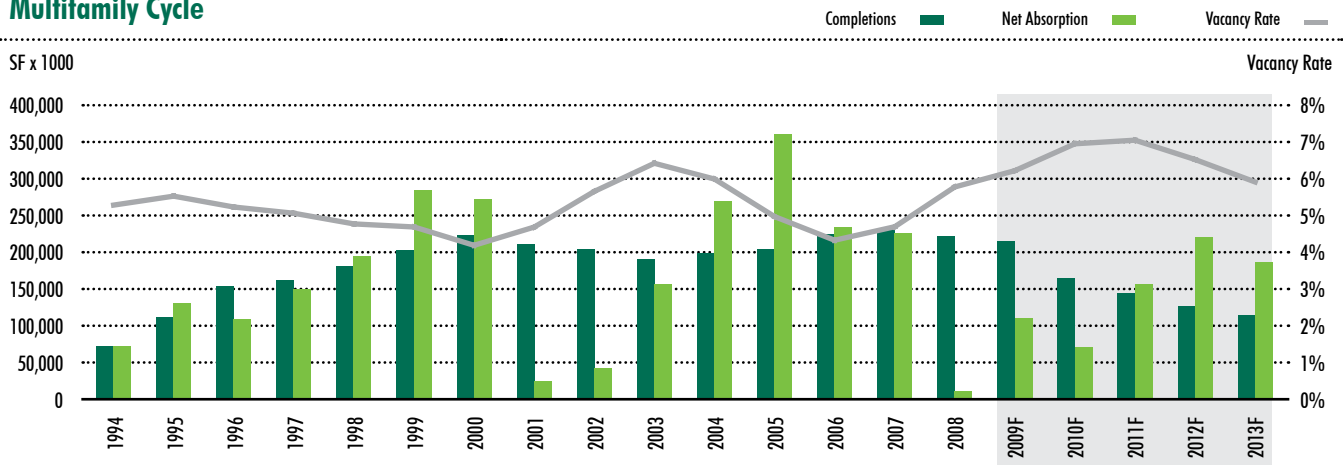
### Retail Cycle



Source: TWR Retail Outlook, Spring 2009

As to multifamily, vacancy will peak in the 2010-2011 timeframe, after which net absorption is expected to recover rather quickly. These vacancy increases tie in directly with the excess of residential housing, cheap financing and, in many areas, fire sale prices on homes. However, as this situation turns around in 2010 and the bargaining power between home sellers and buyers returns to more of an equilibrium, vacancy and net absorption in the multifamily sector will return to their long-term averages.

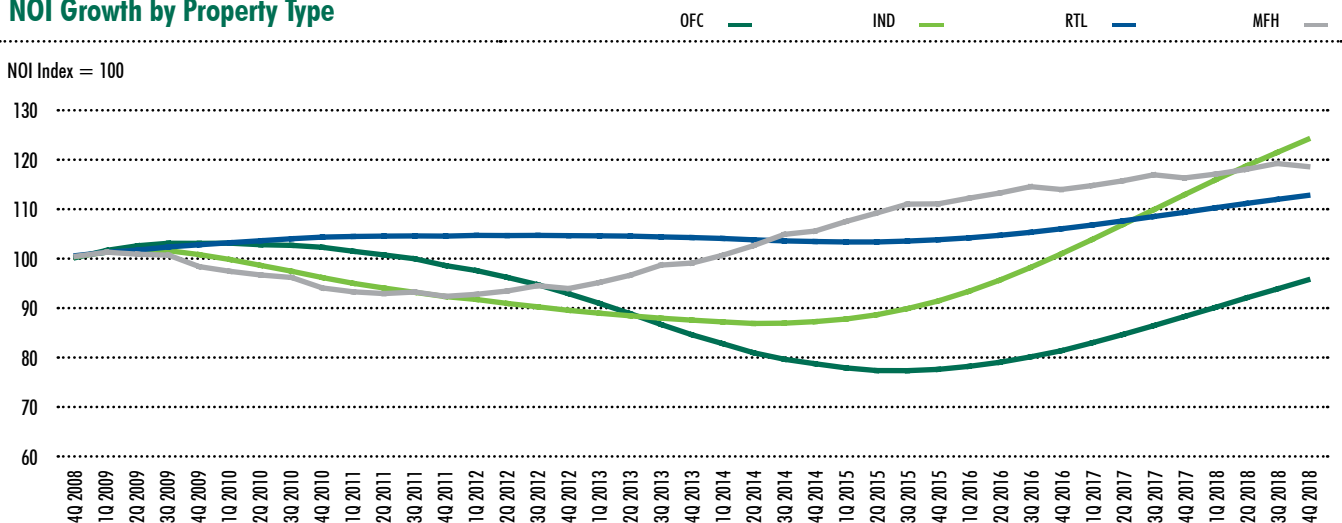
### Multifamily Cycle



Source: TWR Multifamily Outlook, Spring 2009

### INCOME OUTLOOK BY SECTOR

#### NOI Growth by Property Type



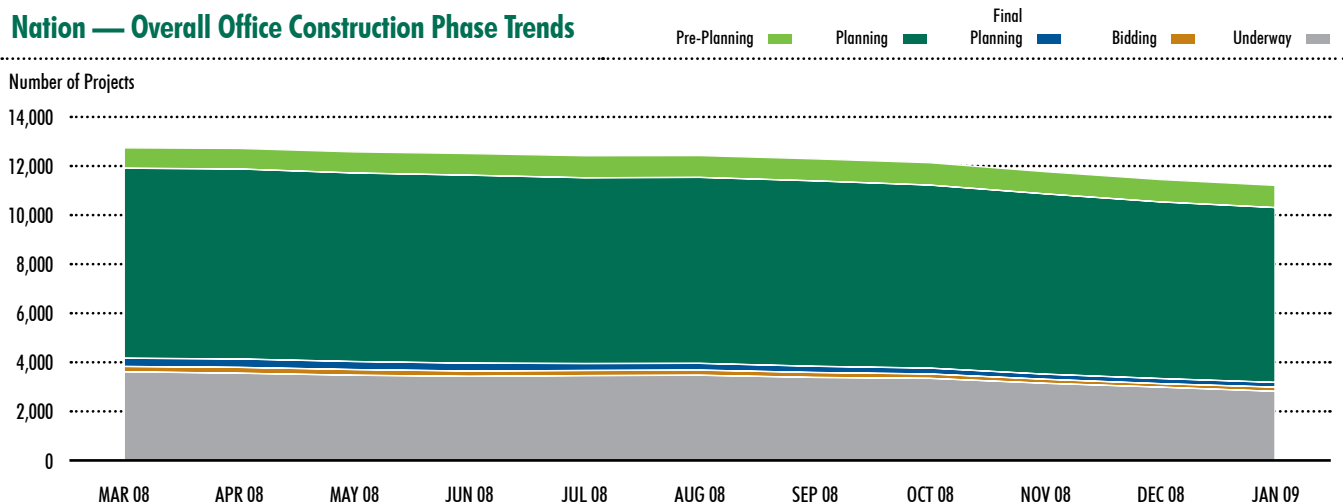
Source: TWR Investment Outlook, Spring 2009

Indexing NOI growth by property type illustrates how some property types will fare far better than others. For office, long leases and the increase in price per square foot as a result of the EOP assets push office NOI higher through 2011. However, after the typical five-year lease term runs out and leases are renegotiated, the income in the office sector takes a hit in the 2013-2015 timeframe. The typically steady income patterns of industrial assets are stymied by uncertainty surrounding the stability of the domestic U.S. economy as well as the outlook for global trade patterns, given the current global downturn. Retail emerges as a consistent income winner, largely due to tenant diversification and the buffer of

grocery and consumer staple anchors. Multifamily does not have quite as consistent of a performance as retail, as the rental market does not improve until the 2010 turning point, identified earlier. After that point, landlords' pricing power returns and rents begin to accelerate.

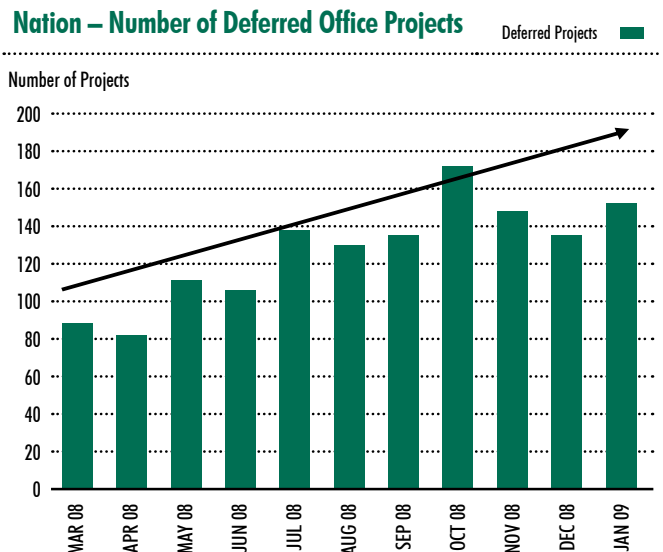
### PULLBACK IN CONSTRUCTION IS THE SILVER LINING

#### Nation — Overall Office Construction Phase Trends



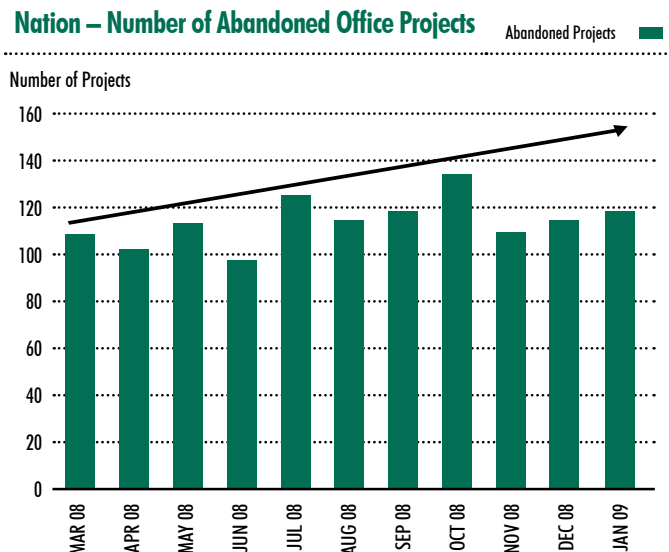
Source: TWR Dodge Pipeline, January 2009

#### Nation – Number of Deferred Office Projects



Source: TWR Dodge Pipeline, January 2009

#### Nation – Number of Abandoned Office Projects



Source: TWR Dodge Pipeline, January 2009

### NEW CONSTRUCTION

Projects underway have been severely impacted by the lack of credit financing in the market today. During the residential housing boom, small, regional banks got into construction lending, since they were largely crowded out of the home mortgage market by big lenders. When the credit crisis hit in the summer of 2007, these small banks were hit especially hard and did not have the capital capacity to sustain the losses. At the beginning of 2008, construction loans at many small and regional banks were non-performing. Data from the FDIC shows that the banking industry

is responding to this. In the fourth quarter, loan loss reserves were up to \$50.2 billion, four times the amount from last year. In the third quarter, nine small banks failed, compared with only two in the second quarter.

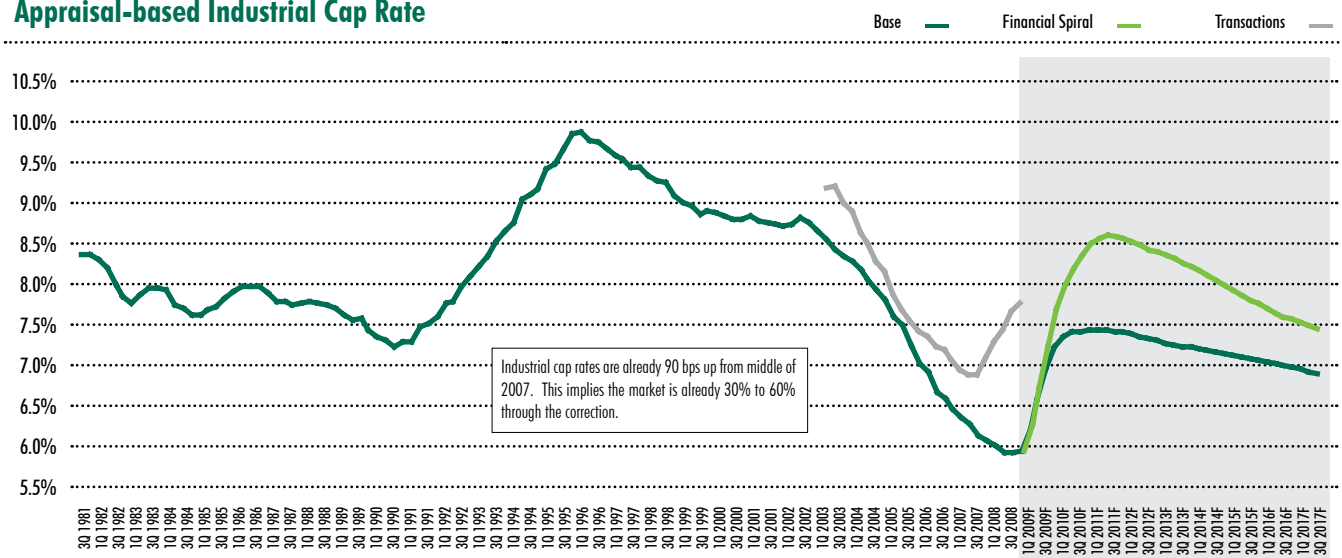
Such statistics have pushed regulators to pressure banks to rapidly reduce their real estate exposure, with more dire consequences such as writing down or calling loans due on otherwise good projects. This has stopped development dead in its tracks. Supply is being cut not only by an outright credit shortage but also by regulation pulling the plug on development projects irrespective of their merits. Construction trends indicate how projects underway have declined, while the number of deferred and abandoned projects has been increasing. We believe this supply stop will persist as long as banks are in the precarious position of being pressured to make low-risk loans and simultaneously shore up loan loss reserves against the next bad loan on their balance sheet.

## CONCLUSION

While many risks remain in the CRE market, the strength of top quartile funds, the income strength of several property sectors, the lack of financing and the opportunities left by those too apprehensive to participate in the current market are all advantages available to the prescient investor. According to Capital Markets professionals, those investors that are participating in the market are currently acting in a herd-like fashion, with buyers only chasing primary markets. For investors whose space is in secondary or tertiary markets, the flight of buyers from these markets represents just one example of an opportunity presented by market distress.

Our research has shown that we are about halfway through cap rate expansion given the concessions already made by the market vis-à-vis transactions. An example of this in the industrial property market is illustrated graphically below. This informs our thinking that by the time economic indicators turn positive, the time for opportunistic buys will be over. J.P. Morgan captured this thought rather poignantly when he remarked, "I never buy at the bottom or sell at the top; I make sure that I'm in that middle 70%."<sup>1</sup> Indeed, waiting for the nadir of cap rate expansion to occur may prove to be too late.

### Appraisal-based Industrial Cap Rate



Source: TWR Spring 2009 Investment Outlook, Real Capital Analytics & NCREIF

<sup>1</sup> We wish to thank Yuri Pill, Vice President of Research at Oxford Properties, for reminding us of J.P. Morgan's words.

**FOR MORE INFORMATION PLEASE CONTACT:**

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