

# Are We There Yet?

Marc Louargand FRICS cautions that even while the rest of the economy appears to be recovering, the commercial real estate market will likely lag behind in its recovery.



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**A**s we exit the middle of 2009 we are still contending a global recession that has had a negative impact on property markets. The outlook for the near term is not better. Given the lagging nature of property market responses to the broader economy, things will probably get worse before they get better. What will it take for things to turn around? Where are we going in terms of occupancies, rents and values? What forces will combine to shape the fortunes of the property market for the next few years?

## The Global Recession

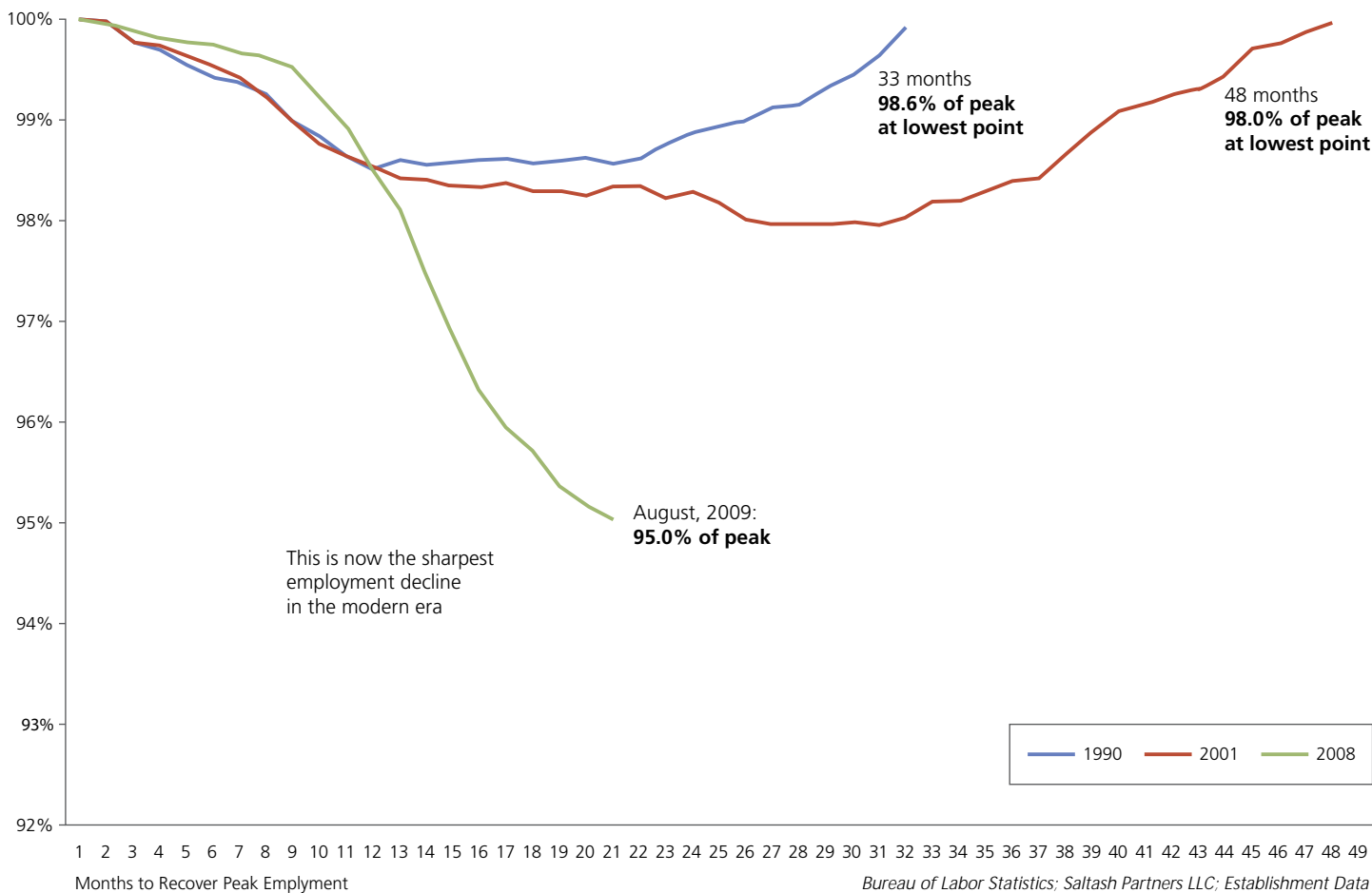
We are still in a global recession which began at the end of 2007. The World Bank forecast contemplates negative GDP change in OECD countries of -4.2 percent with a negative 4.8 percent in non-OECD countries for the full year 2009. Developing countries, which typically have relatively high GDP growth rates, are forecast to come in at only 1.2 percent in 2009. OECD countries are forecast to have a modest recovery in 2010 with GDP growth of 1.2 percent. Some of the world's more robust economies have been hit hard. Korea recently raised its GDP forecast from -2 percent to -1.5 percent. Singapore has released a -4 percent to -6 percent GDP forecast and Brazil is forecast to be -1.1 percent. Only India and China of the BRIC

countries are expected to have positive growth although at lower rates than in past years.

In the United States, the signs are still mixed but many economists are calling for a positive GDP change in the third or fourth quarter of 2009. There are a few positive signs in leading industries. The Book-to-Bill Ratio in Semiconductors rose to .74 in May compared to .47 in January. The Book-to-Bill ratio compares current sales (Book) to shipments (Bill). When the ratio is at or above 1.0 it signifies a healthy electronics market. By comparison, the May 2008 ratio was .86. Things are improving but we still have some distance to go. By contrast, the Book-to-Bill ratio in Japan in May was .40. The OECD reports that leading indicators for most economies pointed up or signified a trough in May 2009. The current recession has been more severe and pervasive than the two previous ones. Job loss in the United States and elsewhere far exceeds the experience of the last two downturns. In order to understand the reaction of the real estate market to the broader economy we need to focus on job loss and job creation.

## Jobs and the Recovery

Readers may recall talk of a "jobless recovery" in the early 2000s. In fact, all recoveries are



**Figure 1: Recent Post-Recession Employment Recovery**

“jobless” as seen in figure 1, Recent Post-Recession Employment Recovery. It took 48 months to regain peak employment in the United States after the 2001 recession, until February of 2005. The percent of job loss in the current recession has been significantly sharper than it was in the 2001 recession, which bottomed at 97.9 percent of peak employment. As of June 2009, the United States had fallen to 95.3 percent of peak employment. It took four years to replace those jobs in the 2001 recession; it will likely take much longer to recover this time. What does it mean for property markets? Figure 1 shows that the previous employment recoveries follow a trend upward from a trough after “bumping along the bottom” for an extended period, about ten months in both cases. This recession is significantly different in both the extent and the speed of job loss in the United States.

Will the recovery resemble past history or not? Employment contraction is far more widespread this time around and that may be something of a silver lining. Traditionally, firms take advantage of a recession to trim costs, remove deadwood and delay rehiring in the recovery as long as possible in order to restore their balance sheets. Given the sharp reduction in jobs, it is possible that firms will find they have a capacity problem early on in the recovery and that they must begin rehiring sooner than

they anticipate. Even if so, it will take an extended period to make progress back toward the peak employment we saw last in 2007. I expect that we will again have a flat bottom for an extended period as we enter a period of mixed results. Some will be rehiring while others are still cutting. How does that affect real estate?

There did not appear to be any significant capacity shortages in the property markets during the last expansion (with the possible exception of hedge fund office space in Greenwich, Conn.). Thus, the property recovery will follow the jobs recovery. For now, the office market remains weak in the United States., United Kingdom and elsewhere with rising vacancies and declining rents. Retail occupancies are suffering as well as retailers go dark in marginal locations or shut down entirely. Regional and super-regional malls are harder hit than in previous downturns while smaller shopping centers suffer as well. Given consumers’ new propensity to save in the face of asset deflation and reduced circumstances, retail will likely take substantial time to come back.

Multifamily properties have seen increased weakness but on a relative basis their fundamentals remain better than other property types. Multi-family will also enjoy the earliest firming of fundamentals as job creation brings household formation almost

simultaneously. Based on behavior by recent graduates, it also appears that there will be a meaningful pent-up demand for apartment rentals that can only be unleashed by job creation.

The office sector has a modest over-capacity at present. Whether it gets worse before it improves will be determined by firms' ability to retain their current staffing levels and remain viable. In the United States, credit markets appear to be turning back toward

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a semblance of normalcy with the exception of the possibility of a CIT bankruptcy, which could have a major impact on several industries that rely on factoring and franchise finance. Expect the market to remain weak for 18 to 24 months. Robust office markets typically require vacancies to fall below 14 percent in the United States while several forecasters are estimating that vacancies will be approaching 17 percent by year-end. Of course, in individual markets the numbers vary widely with some moving into the mid-20s already. But these numbers tend to be in traditional growth markets (with the exception of Detroit) that have shown the capacity to grow jobs at 5 percent to 7 percent per year in recoveries. The U.K. market looks to be in somewhat better shape in terms of the level of vacancy but the relative importance of financial services in the City and the West End could make for an extended recovery period.

The pieces are in place for a slow recovery in the jobs market, which means that real estate fundamentals will remain weak for an extended period and will embark on a slow recovery when the job market begins to rise off its bottom.

How have the decline in fundamentals and changes in the capital markets combined to affect values? The two critical variables are risk premia and leverage ratios.

### Return of Risk

Risk premia have returned to asset pricing. During the recent bubble, buyers made little distinction between the bluest of blue chip properties and those in historically volatile and risky markets. Why was that? Some would argue that it was because the investor was not bearing any risk. The lenders were taking it all. Yet the lenders' rates did not reflect meaningful risk premia either. A cynic might note that the originating lenders were not bearing any risk either since they were slicing

and dicing the paper into increasingly remote derivative claims. Since the ultimate buyers of those claims were comforted by agency ratings that implied low risk, it appeared that a miracle had occurred and that risk was banished from the marketplace. Today the miracle of the disappearing risk has been debunked as just another illusion. The expression of risk is found in the spread of required yields over Treasuries or Gilts or other putatively risk-free instruments. Transaction data from the past two quarters has begun to show a rise in both cap rates and spreads.

### Cap Rates

During the recovery from the 2001 recession, which was accompanied by a modest excess supply of real estate due to economic contraction, Real Capital Analytics reports that the average cap rate for institutional transactions was 8.74 percent during the period January 2001 to December 2005. During the same period the average 10 year Treasury rate was 4.43 percent. The real estate cap rate spread averaged 430.7 basis points during that time. Why were spreads so high? Why was the real estate risk premium nearly 100 percent of the Treasury yield? In the 1980s real estate cap rates had negative spreads to Treasuries. Why? Because investors assumed that the high inflation rates of the period would be reflected in increasing revenues and values if they persisted. During the recovery from the 1990 recession, which was accompanied by a massive excess



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supply of finished product, cap rates traded between 9 percent and 10 percent. Why? Because the specter of inflation had been banished by then. Investors priced property to reflect its inherent risk, returning to a spread roughly equal to the Treasury rate. From early 1992 to the end of 2000, Treasuries traded between 5 percent and 6 percent+. During 1998, Treasury rates pulled back into the 4 percent range and cap rates followed, dipping into the 8 percent range – but bounced back into the nines when Treasuries returned to the 5 percent range in 1999. The failure of Long Term Capital and the

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Asian crisis created a fight to the safety of Treasuries and real estate benefited as a result. But rates came back up in 1999 and remained in the same range until 2002 when the Federal Reserve began its fight against the specter of deflation. Cap rates fell along with Treasuries as liquidity flooded the world's capital markets. The inevitable end to the property pricing bubble has come, evidenced first by a dramatic drop in transaction volume as investors avoided creating a reportable value against portfolios of higher book values. Transactions have begun to come back, perhaps driven by foreclosures or liquidations in pursuit of delivering. Recent cap rates have returned to the 9 percent and even the 10 percent level according to Real Capital Analytics. Where will they go next?

There appear to be two possible paths for cap rates and pricing in the next two to five years. What could drive them back down and what could sustain them at elevated rates?

### Falling Cap Rate Scenario

A return of expectations for high inflation accompanied by improving fundamentals in space markets could combine to lower cap rates dramatically on a relative basis. Recall that property traded at negative spreads to Treasuries during the high inflation years. We had reasonably sound fundamentals in most space markets during those years so investors had a reasonable expectation of being able to raise revenues along with inflation. But remember

that the nominal cap rates were low during that period only by contrast to the very high risk-free rates which failed to completely reflect expected inflation. Will the Treasuries and Exchequers of the world have the discipline to head off incipient inflation from massive liquidity infusions? If we see a Japanese style policy emerge with long-lived low reference rates, we may see falling cap rates again. Another enabler of falling cap rates was enjoyed in the previous cycle – low interest rates accompanied by high loan-to-value ratios. A 90 percent LTV at 5 percent interest means a 6 percent cap rate yields 15 percent to the equity. The likelihood of this arrangement obtaining in the foreseeable future appears dim.

### Rising Cap Rate Scenario

We have already seen a few transactions with markedly higher cap rates. They are likely to remain high if not go higher if space market fundamentals remain weak and inflation remains dormant. Since we are in a balance sheet recession, it's likely that deflationary forces will remain at work in the short run. If so, we should expect some continued decline in values as cap rates adjust upward to a new equilibrium in the 8 percent to 10 percent range. Realize that the cap rate adjustment is occurring while fundamentals weaken and leverage declines – or disappears altogether in some sectors or markets. The combination is likely to bring value declines on the order of 40 percent or more. Based on the institutional return indices in the United States and the United Kingdom, it appears that value declines on the order of 40 percent are a reasonable expectation and in fact have been booked in the case of publicly traded real estate securities. Coincidentally, a shift from a 6 percent cap rate to 10 percent delivers a 40 percent decline in value for a constant income stream. While transaction volume has remained scant, the implications are clear for value. In the case of open-ended funds that are required to revalue quarterly, already we see more than 30 percent declines in the past year.

While fundamentals will continue to weaken for some time, the shift in cap rates will create most of the revaluation.

### Which will it be?

It likely will be both. Persistent high cap rates for a period of at least 12 to 24 months, followed by cap rates falling on a relative basis to Treasuries. The initial phase of recovery will see few if any jobs created, thus investors will lack confidence that they will be able to fill empty space in the short run so they will rely on in-place revenue and be subject to reduced leverage opportunities. At some point, however, the massive liquidity created by stimulus packages around the world will escape the liquidity trap and inflation will come roaring back. Monetary policy response will lead to higher reference rates from central bank actions or from investor pricing.

It could take as many as five years to regain the jobs lost to date. But expectations of a recovery will allow investors to look forward to better cash flows. Investors have shown in previous cycles that they are willing to pay a small premium to have their assets in portfolio when good times return. So after a period of persistently high cap rates investors will come back into the market in sufficient volume to put downward pressure on cap rates and force them to price inflation into their expectations rather than into the cap rate.

In each cycle, animal spirits rise to deny its very existence. Perhaps some memory of the current trauma will remain to inform our decisions during the coming recovery. ●

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