Yeskey Real Estate Consulting & Investments

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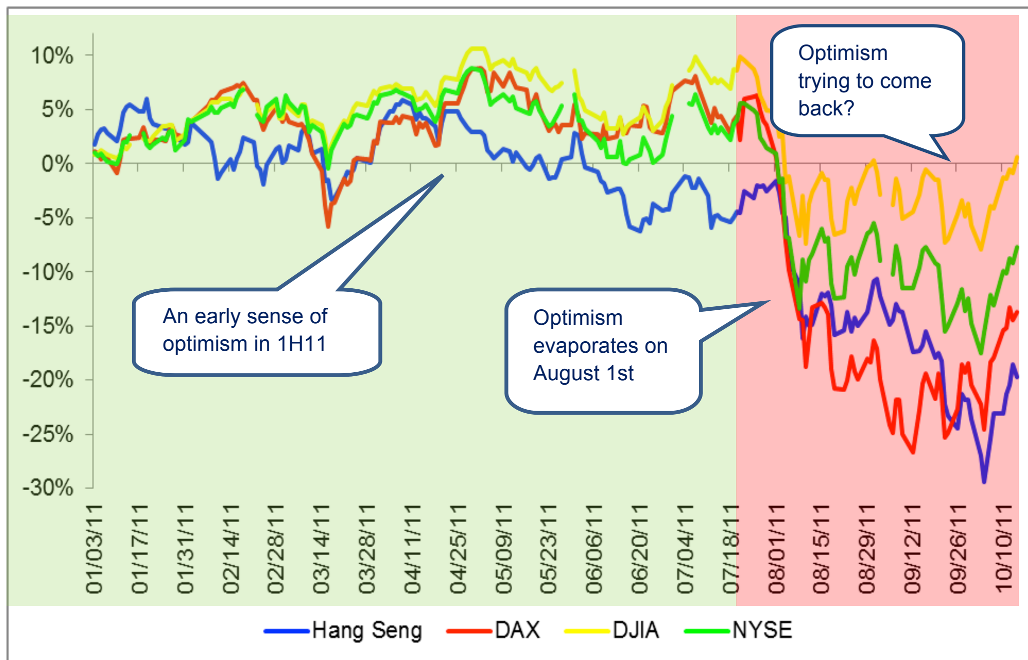
Keeping Clients and Investors Ahead of the Market

FALL UPDATE – "OCTOBER SURPRISES" | OCTOBER 15, 2011

The purpose of this brief is to compare expectations published in our May 31st report with realities that have transpired as of mid-October. In particular, we want to highlight the impact of the "August collapse/September meltdown" of the stock market, which weakened the economy and caused consumer and investor sentiment to darken (Exhibit 1).

This update focuses on key issues impacting commercial real estate, with a particular focus on how the economy, government, fundamentals, equity and REITs, and debt markets have performed against our predictions and the conventional wisdom that prevailed earlier in 2011. While some of the drivers have behaved in line with our spring forecast, others moved in unexpected directions that shed light on the outlook for 2H11 and into 2012.

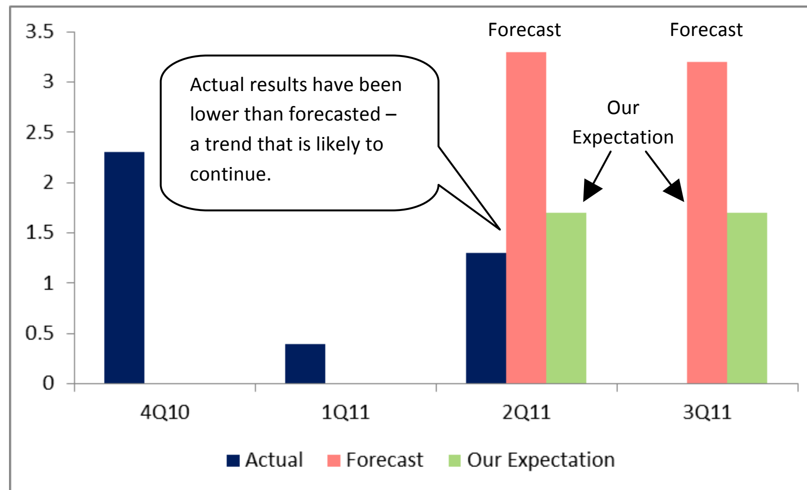
Exhibit 1: Stocks Suffer August Collapse/September Meltdown



THE ECONOMY: MAJOR OR MINOR SURPRISE?

The performance of the U.S. economy has been a big surprise to the majority of forecasters, but not to us. **Back in May, some forecasters were predicting GDP growth as high as 3.8 percent for 2011, but our analysis determined this was too high, and growth in the 1-2 percent range was more realistic than 3-4 percent.** In fact, it appears that "60 isn't the new 40, it is 60" and that modest performance could be a new normal for the economy, as evidenced by growth of 0.4 percent in 1Q11 and 1.3 percent in 2Q11 (Exhibit 2).

Exhibit 2: GDP Growth Significantly Weaker Than Forecasted (% change quarter-over-quarter)



Source: BEA (actual for 2Q11 is as of 9/2011), Global Insight (forecast as of May 2011)

In past cycles, robust recoveries in GDP and employment were driven by factors such as residential real estate, consumer spending, government stimulus, business investment, and imports/exports, none of which appears poised to provide a significant boost in the near term. Given the maturity of the U.S. economy and the lack of traditional catalysts, it appears growth will continue to be tepid heading into 2012 and that unemployment will remain high. However, a closer look at predictive indicators such as the spread between 3-month T-bills and 10-year T-bonds, retail sales, and corporate profits, suggests that a double-dip recession is unlikely in 2H11.

Low growth of 1-2 percent may be the new normal for the economy, but does not necessarily invalidate CRE as an attractive investment, especially for markets such as NYC and Washington DC, and product segments such as apartments, which can thrive at that level in selected markets. Historically, CRE has thrived in major global cities such as London, in spite of low GDP growth nationally.

GOVERNMENT INTERVENTION/NEW RULES: TOP SURPRISE OF PAST 6 MONTHS?

The government is one of the factors with the potential to move the economy forward, and the big surprise so far in 2011 is the dearth of any action that could lead to growth. Six months ago, we believed the government would focus on economic stimulus and debt reduction, and that the momentum of government rulemaking was nearing a peak. We were too optimistic about anticipated action to support the economy, and surprised the government has fallen into a period of profound stalemate, significantly reducing the potential for anything new to be passed prior to the critical election period.

"If you aren't part of the solution, you're part of the problem" - Charles Rosner[i]

Leading the list of factors contributing to the decline of consumer and investor confidence is the lack of new rules in Dodd-Frank, which have remained largely unwritten (Exhibit 3), leading to greater uncertainty, and contributing to economic weakness. We foresaw that rules would be watered down, and we still see this happening, but new rules governing

capital requirements and separating derivatives from investment banking are necessary, and limitations could be beneficial to CRE by discouraging bubbles from forming (Exhibit 4).

Exhibit 3: Dodd-Frank Remains Largely Unwritten, Likely to be Diluted

Dodd-Frank Rule/Provision	Description	Activity
Shareholder Rights	• Shareholders would have "proxy access" to nominate board members and have a "say on pay" for executive compensation.	• Proposed "proxy access" rule challenged in court by corporate lobby, forcing it to start over. Part of "say on pay" is in effect.
Consumer Financial Protection Bureau (CFPB)	• Agency responsible for consumer protection rule making, enforcing new laws, and investigating consumer complaints.	• CFPB has begun to take credit card complaints, but won't be responding to other types of complaints until late in 2011.
Residential Mortgage Standards	• "Skin in the game" provision where institution has to keep 5 percent of loan on its books for loans that do not meet specified criteria.	• Rule making has begun, but remains a year away from full implementation.
Rating Agency Reform	• More extensive SEC oversight of the financial industry to prevent future rating agency failure.	• SEC has completed only two rule changes, a director has yet to be named, and the Office of Credit Agencies has yet to open.
Standards for Brokers and Dealers	• Securities brokers providing investment advice required to meet same standards as investment advisors.	• New rule has yet to be proposed.
Presale Disclosures	• SEC authorization requiring presale disclosures by brokers and dealers to retail investors, including mutual funds.	• Changes have yet to be proposed.
Arbitration Reform	• Bans mandatory arbitration clauses from mortgages, and gives CFPB the mandate to study if arbitration harms consumers.	• Study underway.

Source: bankrate.com, August 2011

Exhibit 4: Details of Proposed Volcker Rules Begin to Emerge

Key Proposed Volcker Rules Under Dodd-Frank	Rule Detail	Rank of Impact to CRE (1=minor, 5=major)	Comment on CRE Relevance
Proprietary Trading	• Limits risky trading by banks for their own benefit. • Banks cold be free of the Volcker restrictions if hedging specific positions or a portfolio of risks across multiple trading desks.	3	• Reduced profits could constrain liquidity available for CRE lending.
Hedge Fund and Private Equity Fund Investments	• Banks wouldn't be allowed to own more than 3% of a fund, and investments in funds couldn't exceed 3% of capital.	4	• Reduction in flow of capital to real estate funds.
Compliance	• Senior bank executives would be responsible for reviewing effectiveness of compliance programs.	3	• Could lead to tighter lending standards for CRE borrowers.
Compensation	• Rule would change the way traders involved in market making activities for banks are compensated. • Traders would be paid from fees and the spread of their transactions rather than the appreciation or profit from their positions.	2	• Could limit appetite for non "core" CRE investments.
Foreign Banks	• Foreign banks would be covered by the rule if they have U.S. based staff involved in the restricted trades.	4	• Could limit some capital available to CRE from banks outside of the U.S.
Non-Bank Regulation	• Although not technically part of Volcker, the Federal Reserve is considering regulating non-bank lenders ($50 billion+ in assets) considered systematically important to the world economy.	5	• Could limit capital available to CRE from alternative sources such as insurance firms and hedge funds.

Source: "Dodd-Frank's Volcker Rule Released by Regulators for Comment," Bloomberg, 10/11/2011

Rarely, if ever, have we seen such a rapid shift from the spring optimism to the extreme pessimism that resulted in the August collapse and September meltdown of the stock market! **In our May analysis, we agreed with conventional wisdom that there would be**

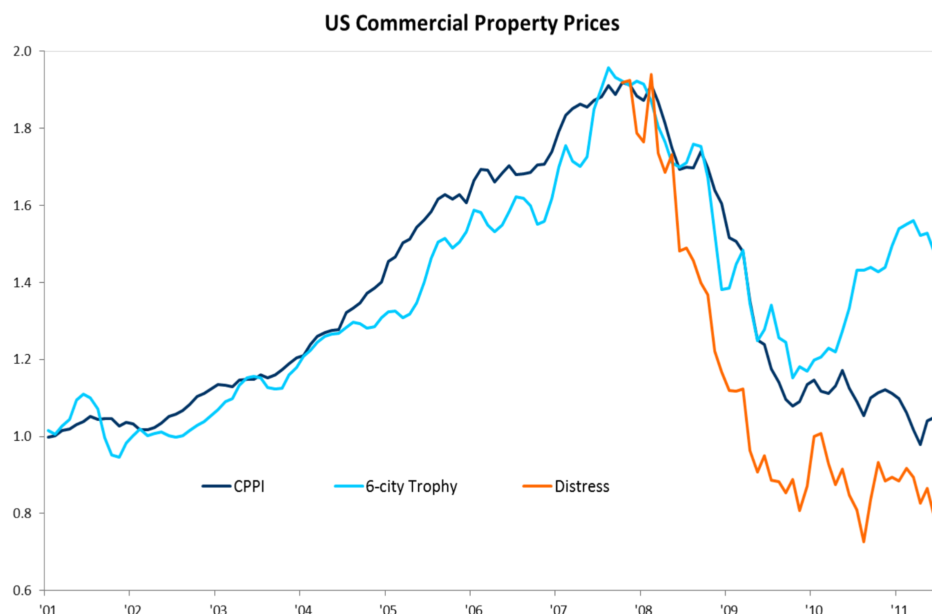
some level government action to support growth. Perhaps we were too naïve, but we still believe the government must take effective action and move forward with writing new rules in the next six months, or we will suffer the consequences of potential recession, higher unemployment, and further declines in consumer and investor confidence. This is also true of governments in Europe, where inaction contributed to the global stock market meltdowns in August and September.

CRE FUNDAMENTALS: NOT AS SURPRISING AS YOU MIGHT THINK?

Despite the weak economy and lack of government action, the performance of fundamentals is the source for some good news for commercial real estate. Fundamentals such as vacancy and rent continue to recover gradually, especially for multifamily and some office and industrial, with retail continuing to lag, all depending on job creation. Hospitality had been moving up significantly, but the stock market volatility of August and September should put a crimp in business travel into 2012.

Values have increased, and cap rates have also improved, following several years of flatness. Vacancies have begun to fall, rents are going up somewhat, and best of all there has been minimal new development. Most importantly, as we predicted, there has been a rise in CRE transactions, driven by bank REO and debt sales. Price increases continue to be driven by a "flight to quality", favoring trophy properties in major markets (Exhibit 5).

Exhibit 5: Flight to Quality Continues, as Trophy Markets Rise Above Index



Source: RCA, Geitner, Data through July, as of 9/22/11

What we are seeing today is an expectations gap, but not a fundamentals gap. **In our spring report, we believed that fundamentals were more or less tracking historical norms, but slower, and we still believe that to be true (Exhibit 6).** The slow growth of fundamentals will continue, and will probably be even slower due to the August collapse/September meltdown

of the stock market. However, the CRE recovery should proceed, and a return to sharp declines in occupancy and rent is unlikely heading into 4Q11.

Exhibit 6: Historically, Office Vacancies Improve Gradually Following Recessions

Source: CBRE Baseline Forecast as of 1Q11

EQUITY AND REITS – POSITIVE SURPRISES AHEAD?

The availability of equity for commercial real estate deals continues, driven by extreme stock and bond market volatility, and incrementally increasing investor interest in CRE. **In our spring report, we saw equity and REITs as a positive story, and subsequent developments have supported our estimate, despite declining REIT returns.** REITs have gone negative, but this is not necessarily a major surprise, given the thinness of the market (Exhibit 7).

Exhibit 7: Despite Declines, REIT Returns Continue to Outperform Some Aspects of Stock Market

	6/30/11	8/8/11	9/15/11	9/22/11	9/30/11	10/5/11	10/14/11
Gold 1oz Spot	7.11%	20.46%	26.79%	22.52%	15.26%	16.33%	19.39%
Barclays US Composite Bond index	3.12%	6.07%	6.59%	7.98%	6.79%	6.69%	6.30%
DJIA (US)	7.23%	-6.63%	-1.25%	-7.29%	-5.74%	-5.51%	0.58%
NASDAQ Composite	4.55%	-11.13%	-1.73%	-7.43%	-8.95%	-7.25%	0.56%
DJ All Equity REITs (US)	9.88%	-10.99%	3.05%	-6.14%	-6.58%	-7.96%	-2.18%
S&P 500	5.01%	-10.99%	-3.86%	-10.18%	-10.04%	-9.03%	-2.63%
DJ All REITs (US)	7.03%	-12.93%	-0.20%	-8.68%	-9.54%	-12.98%	-6.58%
NYSE Composite (US)	4.46%	-13.41%	-7.97%	-15.54%	-14.72%	-14.06%	-7.70%
Russell 2000	5.59%	-16.93%	-8.95%	-17.89%	-17.80%	-16.02%	-9.08%

Source: Yahoo! Finance, as of 10/14/2011

REITs are often a useful leading indicator, and bear watching for a glimpse of how the CRE market will perform over the next six months. Going forward, we would not be completely surprised to see REITs continue to trail the stock and bond markets. However, REITs retain positive qualities such as dividends, rents are holding up, and REITs are still relatively well-positioned compared to the government, economy, and even CRE fundamentals.

With the extreme stock market volatility in August and September and dropping prices in the stock market and commodities, investors have exited stocks in droves, and CRE is looking more attractive as an alternative. Heading into 2012, investors will continue to favor high quality REITs, especially in stabilized, mature "core" markets.

DEBT MARKETS – CHALLENGING SURPRISES?

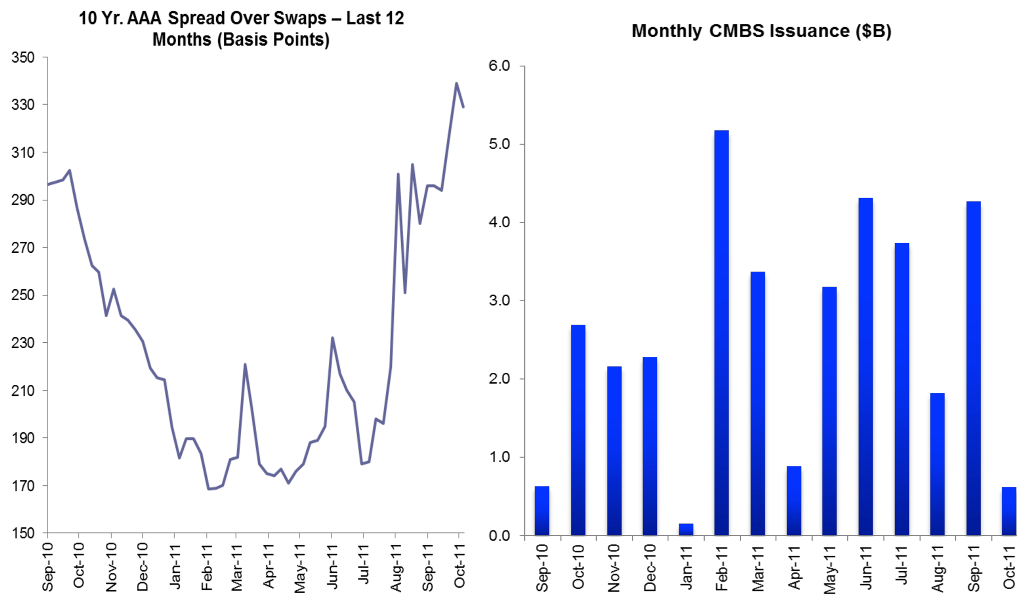
Like government intervention, debt markets are another area where we underestimated just how significant changes would be. **In our May report, we expected banks would remain "back in business" for CRE borrowers, but this trend appears to be hesitating.** Debt markets, which had been opening up distinctly in 1H11, seem to have hit the pause button. The market meltdown of August and September has resulted in an October surprise, in that some debt expected to be available for CRE deals won't be there, due to the following factors:

- Negative sentiment about potential double-dip recession (which we believe is not going to happen)
- Government regulation of banks, while watered-down, is increasing, especially related to the Volcker Rule and capital requirements
- The government has decided to sue banks over subprime abuses
- Big bank's stock prices have declined significantly

Contrary to popular belief, debt is still available for high quality "core" stabilized assets and borrowers, but that might not be true for long. Specialty financing options remain prevalent, but availability is pausing. Insurance firms continue to lend, but may be approaching the end of their allocations. Going forward, we expect to see a second round of "extend and pretend" and more workouts. In addition, we would not be surprised to see the big money center banks look to take further write-offs on CRE debt in order to clean up balance sheets in anticipation of 2012.

The really bad news is the CMBS market, which we were concerned about in May, and has not benefited from structural improvements. CMBS issuance has certainly encountered a significant disruption since May, as large pools formed by bank sellers were unexpectedly not securitized and shelved (Exhibit 8). Rating agencies refused to update ratings, and most importantly, investors balked at too narrow spreads in various tranches. As a result, there has been a series of events including issuance delays, reworking of structures, and significant increases in spreads of tranches, all of which confirmed our concerns about CMBS. In this case, our spring estimate was on track, and we expect CMBS issuance to remain low heading into 2012.

Exhibit 8: Return of CMBS Stumbles, With Good Reason



Source: Trepp, CMAAlert.com

CONCLUSION: MORE SURPRISES AHEAD?

While many of the expectations in our spring report were right on track, very few of predictions offered by forecasters early in 2011 have come to pass. In fact, seldom has conventional wisdom been so wrong on so many counts:

- The economy didn't build on its initial recovery
- The government didn't pursue supportive action
- Dire predictions about overly stringent new rules killing the economy didn't happen
- CRE Fundamentals and REITs held in there instead of taking a step backward
- Despite more equity available for deals, CRE transaction volume trailed expectations
- Debt markets did start to recover somewhat, but not because of CMBS

These surprises may only be the beginning, so stay tuned for our fall report, which will provide an outlook for commercial real estate and its indicators and drivers in 2012 and 2013.

CONTACT INFORMATION

Dennis P. Yeskey
Managing Partner/Founder
dennis@yeskeyrealestate.com

David Garcia
Research /Writing
david@checkresearch.info

Peter Culliney
Research/Data Presentation
pete@checkresearch.info

You can also reach us at www.YeskeyRealEstate.com

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[i] *While Eldridge Cleaver is often cited as having coined this phrase in a 1968 speech, Charles Rosner, a renowned advertiser and marketer from the 60s through the 90s, actually wrote "If you're not part of the solution, you're part of the problem" for VISTA as a recruitment slogan in 1967.