



The End of the Beginning

Michael Acton

AEW Capital Management

Writing from the nadir of the Allied war effort in 1942, Winston Churchill said: "Now is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." In a similar vein, market observers today are starting to suggest that perhaps the "end of the beginning" is at hand in the struggle to place a floor under the global financial system.

After global coordinated government efforts and unprecedented market interventions, the immediate risk of "financial Armageddon" appears to have passed. The overnight dollar borrowing market has slowly returned toward "normalcy," with the overnight rate once again matching the federal funds rate and the three-month dollar rate inching toward 1% at year-end. The "crisis," however, is far from over.

Property investors today are dealing with two fundamental and related problems that flow directly from the broader collapse of global credit markets: (1) a continued dearth of debt capital across nearly all aspects of the economy; and (2) a rapid deceleration of aggregate economic activity resulting from the shutdown of credit and, more significantly, the beginning of debilitating deflationary expectations.

In effect, the US economy (and by extension the global economy) has now fully entered the much feared feedback loop part of this cycle that we had hoped to avoid. Collapsing credit availability is now directly distorting economic decision making, resulting in a more rapid decline in employment. This decline in employment is feeding directly back into the beleaguered housing market, causing yet another round of defaults and foreclosures and resulting in further capital losses and credit tightening. It is this aspect of the current environment that is weighing most heavily on investors as they look forward to earnings and profitability across all sectors of the capital market.

Income effect and wealth effects

During 2008, the US economy lost more than 2.5 million jobs, the most in a 12-month period since 1945. Initially concentrated in housing and finance-related sectors, job cuts have, in recent months, spread more broadly across the economy, both geographically and by industry. The obvious consequence of this is that individuals and families have less income to spend and their concern about their future has grown more pessimistic as evidenced by the lowest consumer confidence levels on record. At the same time, we estimate that US households have lost approximately US\$10 trillion of aggregate wealth through falling home prices and stock values.

Various studies have demonstrated that individuals and households tend to spend approximately 5% of their perceived wealth annually. As such, it would be reasonable to expect aggregate spending to drop by roughly US\$500 billion in response to the extreme decline in aggregate wealth. The combined effect of falling employment (and aggregate income) and declining wealth pose a daunting challenge for the largely consumption-driven US economy and offer the most compelling argument in support of a large-scale government spending program.

Until recently, some of this loss of aggregate demand was offset by rapidly growing exports, driven partly by a very competitive US dollar. With recession taking hold across most of Europe, Japan and Australia, it is unlikely that export growth will continue to provide the same support to the US economy as we move through 2009. Reflecting this, we expect US aggregate economic activity to contract, at least through 2009, with peak-to-trough declines in real output of at least 3.5%. This suggests total employment losses of more than four million jobs, with the unemployment rate rising above 9% during the first half of 2010. The hallmark of this recession will be its breadth – virtually every industry and geography will be impacted to some degree.

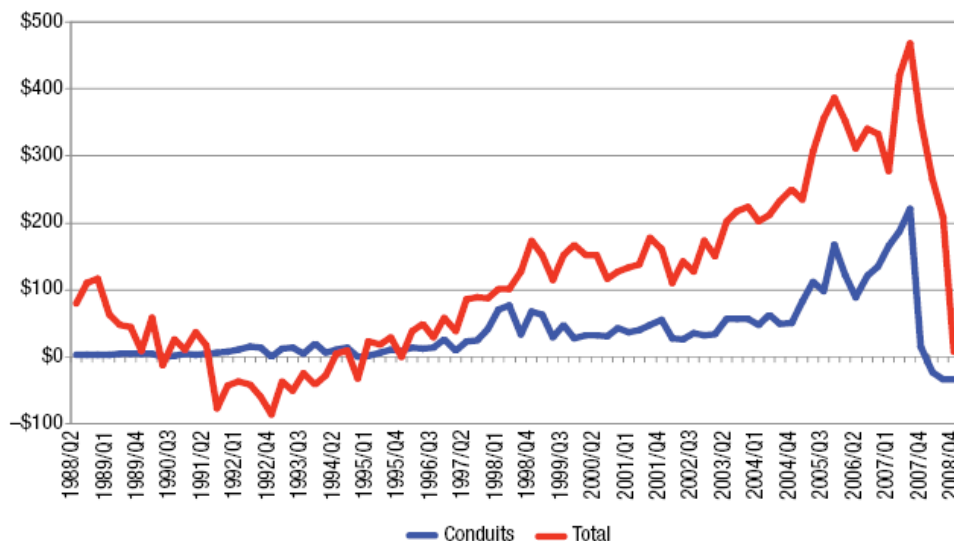
Lending shuts down

The most significant impact of the global credit crisis on commercial property thus far is the near shutdown of the commercial mortgage lending market during 2008. Net flows of capital into commercial mortgages expanded rapidly during this decade, increasing from a stable annual rate of approximately US\$100 billion to



US\$150 billion between 1999 and 2003, to a peak of more than US\$400 billion during the first half of 2007. The majority of the growth in mortgage capital during this time came from mortgage conduits, entities that originate mortgages for the purpose of securitisation. Indeed, by 2007, mortgage conduits had grown to represent roughly half of all commercial mortgage lending as investors around the globe aggressively bought the resulting commercial mortgage-backed securities. This provided mortgage conduits with the low cost capital they needed to be “best rate” lender in the market.

Figure 1: Net Capital Flows into Commercial and Multi-family Mortgages

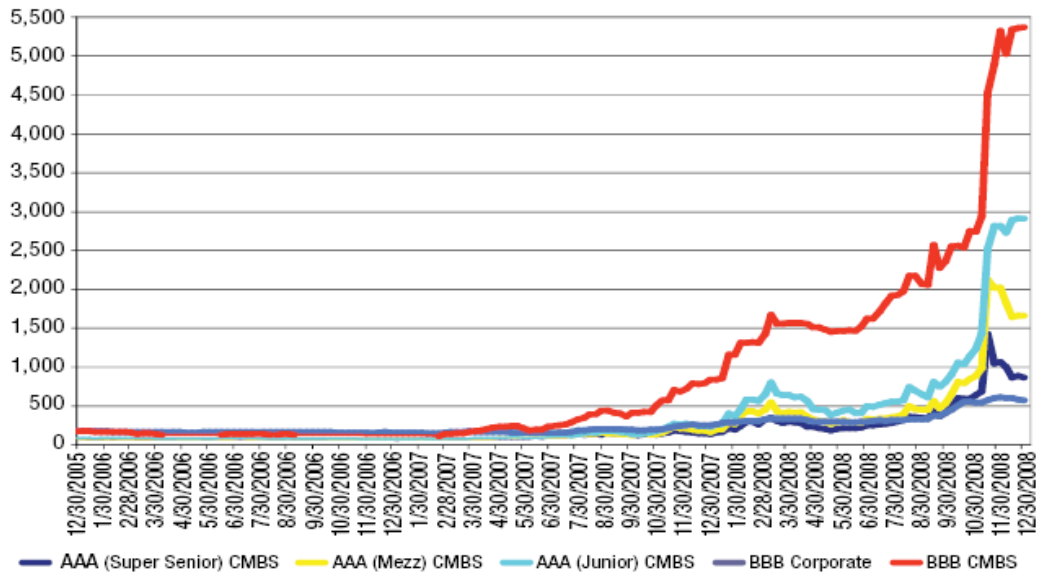


Sources: Federal Reserve, Flow of Funds

By the middle of 2007, however, the CMBS market began to shut down as investors demanded higher yields from mortgage-backed securities in response to growing concerns over the underwriting of the underlying mortgages. Since that time, investor concerns escalated, resulting in a dramatic and unprecedented increase in CMBS yields across the entire credit rating spectrum. The yield spread for various AAA CMBS ranged from nearly 1,000bps to more than 2,500bps (see Figure 2). For comparison, the yield spread for the average BBB corporate bond in November 2008 hovered around 500bps. In other words, investors were demanding significantly less yield from a BBB corporate bond than the safest AAA commercial mortgage-backed security



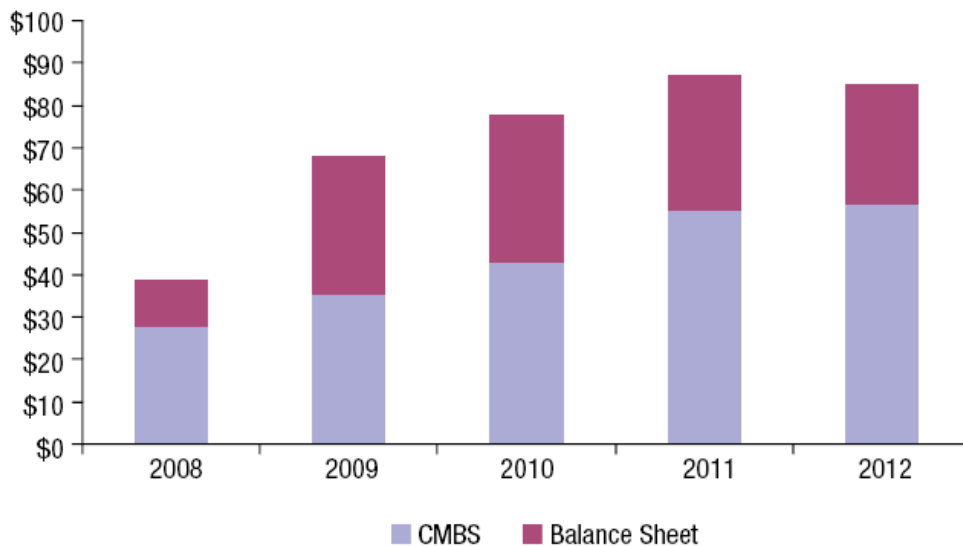
Figure 2: Yield Spreads to 10-year Treasury Bonds



Sources: Bloomberg, Morgan Stanley Capital Markets

The net result of these dramatic changes in the market for securitised mortgages has been a complete shutdown of mortgage issuance by securitised lenders. This has led to almost complete reliance in the market on “balance sheet” lenders, primarily insurance companies as well as the government entities – Fannie Mae and Freddie Mac for multi-family property loans. During the second half of 2008, the net flow of capital from balance sheet lenders fell to near zero and would have been negative without Fannie Mae and Freddie Mac lending on multi-family properties. Life companies and other non-bank financial institutions are now struggling with the same loss of investment value issues that are plaguing all investors as the broader equity markets continue to decline. As a result, significantly lower loan capacity across the entire sector is expected during 2009 and possibly beyond. In the near term, life companies may well find it more rewarding to purchase existing mortgage-backed securities at extremely high yields than to issue new mortgages.

Figure 3: Total Loan Maturities by Year

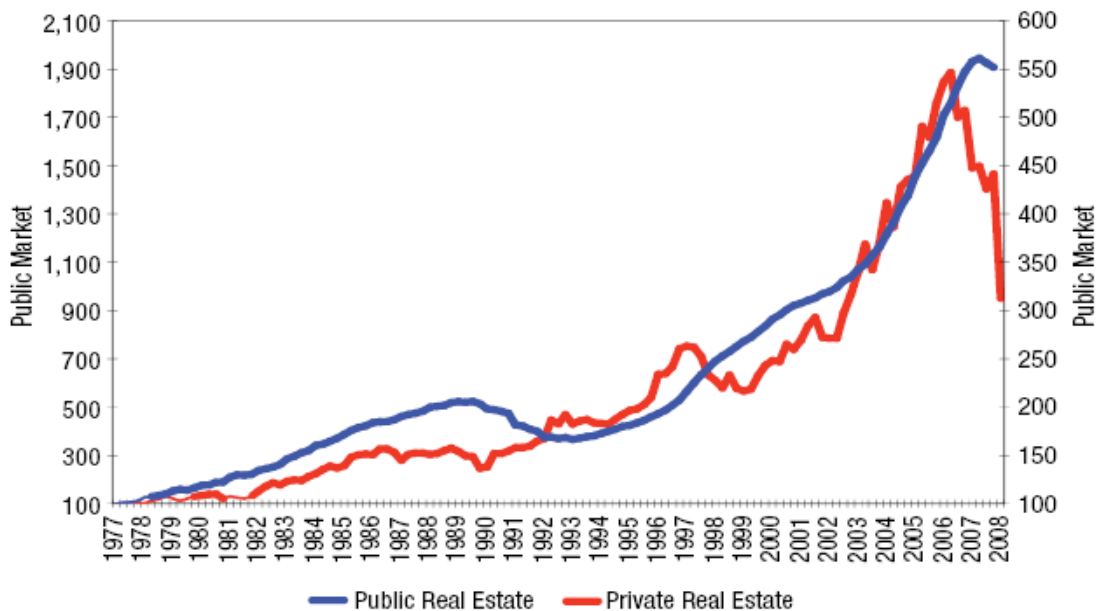


Source: PPR



The lending capacity problem is further exacerbated by an accelerating pipeline of existing mortgage maturities over the next several years. Figure 3 illustrates the dollar volume and breakdown of maturing securitised and non-securitised (balance sheet) loans. As shown, the total dollar value of loans maturing increases from a relatively modest US\$40 billion in 2008 to more than US\$90 billion in 2011. If the total lending capacity of the sector does not increase through expansion of balance sheet lenders or the return of securitised lenders, there will be a significant shortage of mortgage capital for maturing loans as well as new origination.

Figure 4: Inflation-adjusted Total Return Indices for Public and Private Market Real Estate



Sources: NAREIT, NCREIF, AEW Research

Figure 5: Changes in Commercial Mortgage Underwriting

	PreCredit Crisis	Today
Maximum loan-to-value	70%–75%	50%–60%
Minimum debt service coverage ratio	1.05x	1.20x–1.40x
NOI Underwriting	Borrower's pro forma NOI	Current in-place NOI
Spreads	85–125 bps	350–500+ bps (no transparency)
Loan proceeds	Sized using I/O DSCR	Sized using amortizing DSCR
Amortization	10 years I/O	3 years I/O on 10-year loan
Loan requirements	Minimal	Requires structuring (holdbacks, earn outs, TI escrows, recourse)

Source: AEW Capital Markets



In response to these conditions, lenders have tightened the terms of lending and increased the cost of borrowing. In many ways, these changes represent a return to underwriting standards that had existed in more normal capital market periods in the past but, in contrast to the past several years, seemed draconian. Figure 5 illustrates some of the key aspects of these changes. Of particular note, loan-to-value and debt service coverage tests have become far more stringent and the reintroduction of loan covenants has, to a large degree, returned control to the lenders. The most significant impact of these changes, particularly the debt service coverage requirements, is a dramatic reduction in loan proceeds. Even when assuming no valuation change for an asset, average loan proceeds are likely reduced by 30% or more with the new underwriting. For a loan coming due, the obvious implication is that the “debt event” is now more accurately described as an “equity event,” when the borrower will be forced to put more equity into the property or secure an expensive mezzanine loan to bridge this gap.

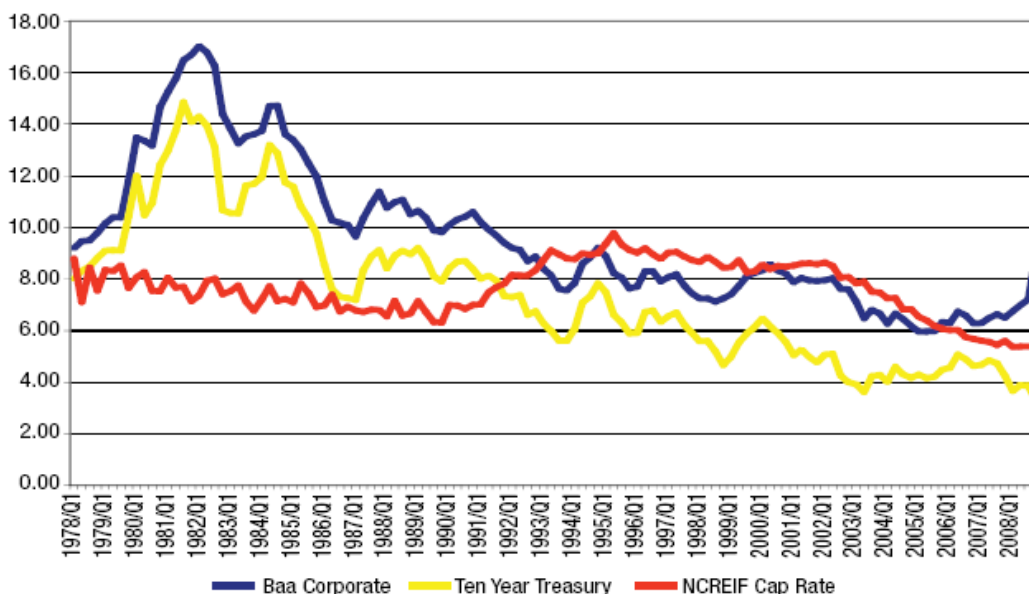
Real assets re-price

Amid the maelstrom of roiling global markets for equity and debt, private market real property has thus far remained a relative oasis of stability. Indeed, through the third quarter of 2008, commercial properties in the US recorded almost no diminution of “reported” value, while equity markets around the globe have dropped to previously unthinkable levels. To date, the total capitalisation of the Wilshire 5000 has fallen to levels last seen in 1997, effectively wiping out an entire decade of stock market gains for a wide swath of investors. More significantly for real estate investors, US and global REIT markets have sold off aggressively, particularly since the end of September, with the US REIT market declining by more than 40% for the year, as the reality of job losses and wealth destruction radically changed near-term growth and earnings expectations. Indeed, as of year-end, the US REIT market was trading at a dividend yield of 7.5% and an implied property capitalisation rate of approximately 8.5% compared with an income yield and capitalisation rate of less than 5.5% in the private market as measured by NCREIF.

The impact on private market property values

Commercial property values in the US are clearly going to decline over the next several years, and this decline will, as always, comprise two components – a pricing effect (yield) and an earnings effect (NOI). Average property yields in the US, as reported by NCREIF, are close to 5% for properties that were held as of 30 September 2008. In normal times, this yield would be viewed in a broader context of Treasury and “risk” yields (see Figure 6).

Figure 6: Cap Rates and Bond Yields



Source: NCREIF, Bloomberg



Typically, investment-grade corporate bonds trade at yields that are roughly 200bps above comparable term Treasury yields. Today, that spread is more than 600bps with 10-year Treasury yields hovering between 2% and 2.5% with BBB corporate yields hovering near 9%. In this environment, real estate looks reasonably priced relative to Treasury bonds but expensive relative to corporate bonds. By any standard, the pricing of real estate today is far more rational than the pricing that existed throughout the 1980s, when average property yields (cap rates) remained consistently below both Treasury yields and corporate bonds.

Another metric often considered is the comparison of equity yields to debt costs. The use of leverage should, in normal times, be accretive to return. In other words, equity yields should be higher than debt costs. Today, there is little or no commercial mortgage debt capital available as mortgage conduit lenders are essentially out of business and balance sheet lenders have little or no balance sheet capacity remaining. Quoted mortgage rates, therefore, mean very little; however, the guidance that they give to equity valuations is decidedly negative. Lenders today are quoting a range of 350bps to 500bps over comparable term Treasury bond yields. With the five-year Treasury yield below 2%, this implies five-year debt costs of 5.5-7%. With an eye toward the higher end of this range, many are now considering the possibility that average property yields may well move up 100bps to 200bps during the next several years.

Implications for the real estate investor

For the real estate investor, the changes that already have occurred, and the changes that we anticipate, suggest several things.

First, while real asset values are likely to decline as they do at the end of each cycle, it is the abruptness and potential severity at the end of this cycle that is most disconcerting to many investors. In this environment, all assets must be evaluated as “haves” that are worthy of defence or “have-nots” that should not be defended. Capital must be reserved for the defence of the “haves,” whether it is working through loan maturities, higher capital allowances for new and existing tenants, or some other as yet unforeseen event.

Second, as difficult as the re-pricing process is for existing portfolios, the cycle does, as always, create opportunities to deploy capital at yields and returns that were not possible in recent years. In the near term, these opportunities are likely to be related to the problems of others: debt maturities and operating defaults. Maturing loans will require new capital in some form, either increased equity or some form of mezzanine debt. The people that need this capital will be price takers, and the providers of this capital will be price setters.

Third, as we move through the cycle, the value of nearly all assets will be impacted to some degree. Initially, the largest valuation changes will happen to the lowest quality and least well-located assets but will, in time, spread to higher-quality assets and better locations as the economic and capital market issues take years to fully play out. As long as the debt markets remain constrained, the pressure on pricing will be such that going forward unleveraged returns should move toward the expected leveraged returns of the recent past. This valuation adjustment has already occurred in the public (REIT) market and is just beginning in the private (NCREIF) market. While there is clearly no need to rush, the benefits of having capital available and ready to transact at the appropriate time are always significant.

The near-term outlook

Looking ahead, there remains great economic and financial system uncertainty. The modern economy has grown extremely dependent on an abundance of inexpensive capital, and the systematic withdrawal of that capital (deleveraging) will represent a challenging and uncomfortable period of adjustment for many businesses and individuals. As noted above, we expect the economy to contract through 2009 and, perhaps more significantly, grow below potential for a prolonged period, perhaps several years.

Indeed, if the economy does not do so of its own accord, policy makers may well be forced to slow growth below potential as part of the unwinding of the financial system support structures that have been put in place over the past year. Governments across the globe have injected trillions of dollars of liquidity and balance sheet—repairing capital into the markets in a very short period of time. Today, there is little danger of accelerating inflation as asset price deflation is spilling over into general price levels and there is hardly any velocity to money. Presumably, as the gloom of deflation fades and the financial system begins to restart, increasing velocity of money could lead quickly to accelerating inflation. Thankfully, the Federal



Reserve and other central banks have a well developed play book to deal with any resulting inflation. Unfortunately, as current events attest, the play book for battling deflation is far less developed and, in some ways, the actions of recent weeks and months give the impression that policy is being “made up as we go along,” which to a large degree it is.

As George Santayana observed, history has a cruel tendency to repeat itself, particularly when the lessons that were supposed to have revealed themselves in the earlier period are ignored in the current period. For the second time in less than two decades, we are dealing with extreme economic disruption flowing directly from a rapid and unregulated expansion of credit. In the last cycle, the late 1980s and early 1990s, commercial property was at the centre of the crisis. Today, it is residential property encumbered by a long list of “innovative” mortgage products and a related alphabet soup of structured investment vehicles built upon them. It is very likely that many of the efforts to “fix” the credit markets and stabilise the economy will prove ineffective and perhaps even counterproductive, but the sheer size and speed of the attempts to address the problem give us hope that we are indeed at least at the “end of the beginning” and perhaps at the beginning, not of the end, but of the next chapter in the ongoing cycle of investment.

Michael Acton is the director of research at AEW Capital Management.

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