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# Recovery and Stabilization Commercial Real Estate

Everett (Allen) Greer  
Greer Advisors, LLC

October 13, 2011 – Lee & Associates - Las Vegas

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**Greer Advisors, LLC**

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# Goals of Presentation

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- Disclaimers
- Market Drivers
- What Broke
- Financial Regulations (Dodd-Frank)
- Investment Banking
- Market Conditions (Sales Volume, Price PSF, Cap Rates)
- Expected Changes / Outlook
- Greer's Forecast / Signs

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# Market Drivers

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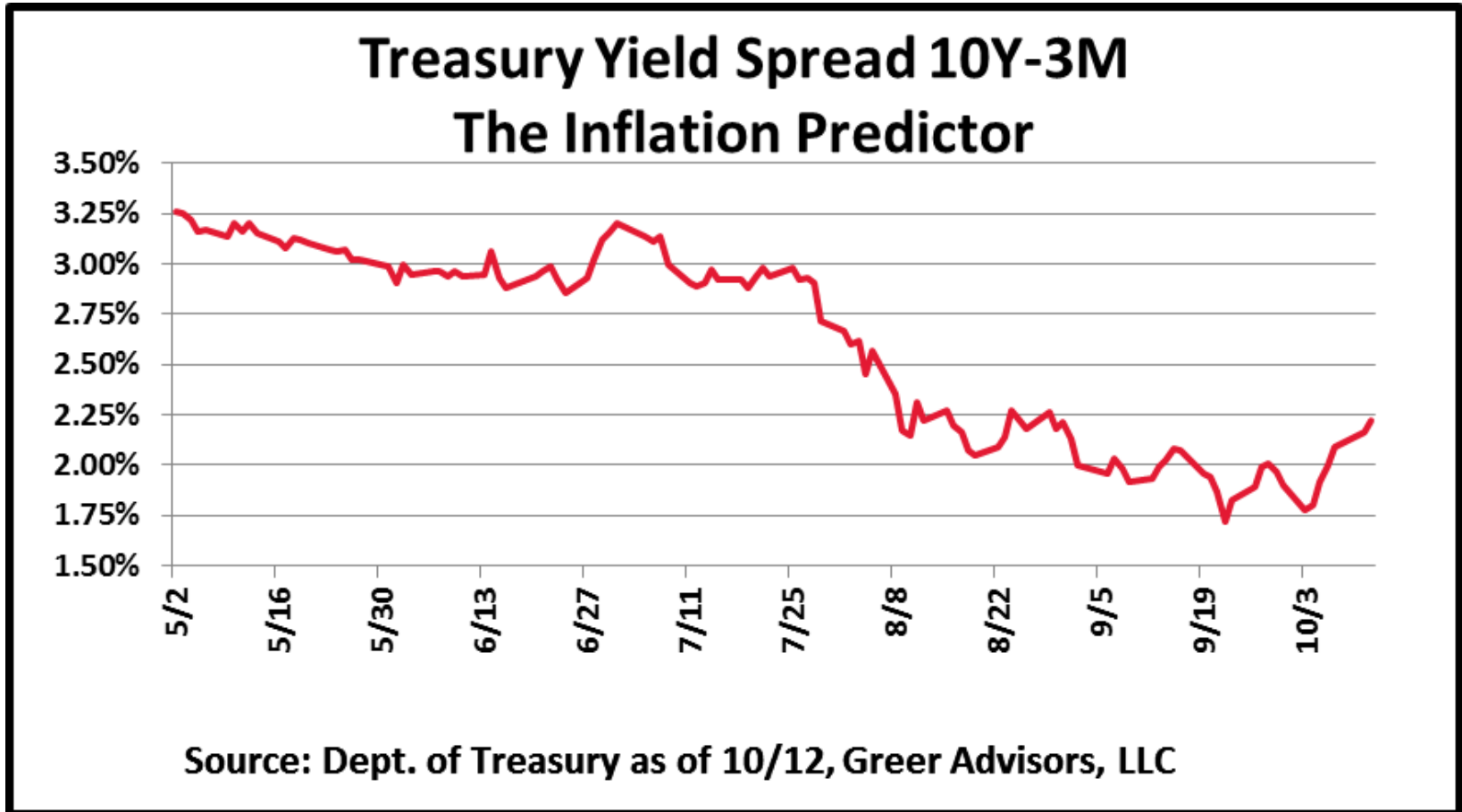
**Supply / Demand** – Not as bad as early 90's

- Non-Res. Supply Growth was Very Limited Growth
- Most Demand ties to Jobs, which is tied to GDP
  - Office – FIRE Employment, Portion of Service Employment
  - Retail – Household Formations, Income Growth
  - Industrial – Manufacturing vs Distribution
  - Multifamily – Households
  - Hotel – Corporate Travel – Office Employment
- Jobs & Retail Sales - Drive Supply & Demand!!!

**Financing – Is the Most Important Fundamental**

- Leverage, Rate, Term, Recourse

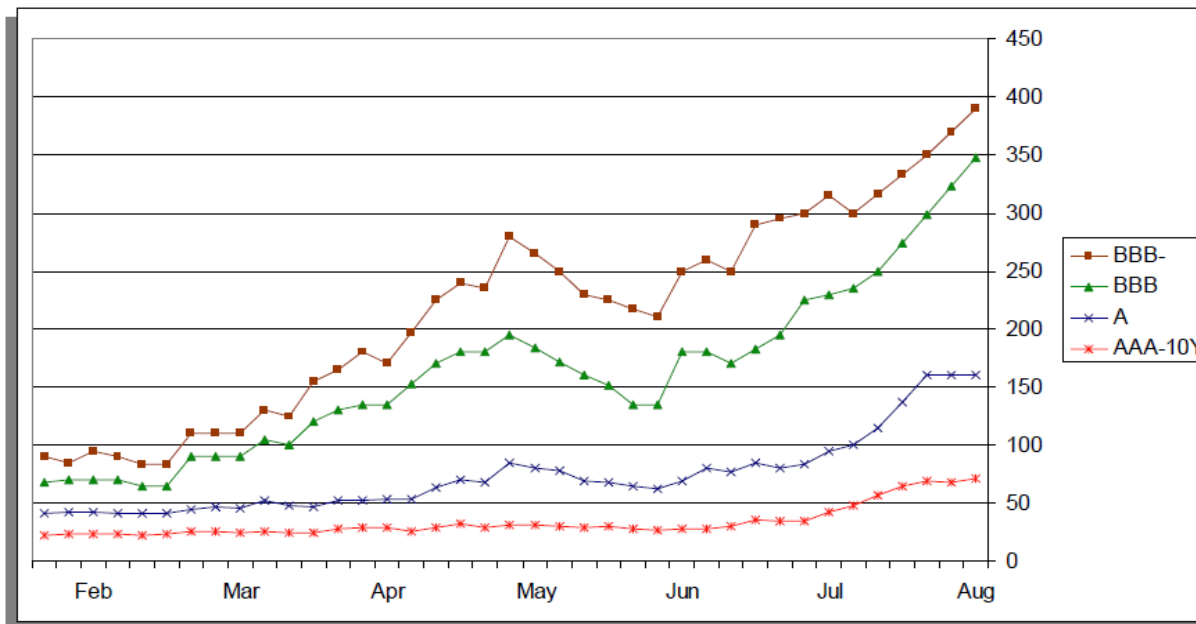
# Into to What Broker – Inflation & Interests



# What Broke Real Estate – Yield Rates

- Slide from 8/3/2007 Presentation to Lee & Associates LA

## CMBS Spreads are Widening - Pricing Trends



Source: CMAalert 8/10/07, CMAalert-Morgan Stanley 8/8/07, Bank of America - Real Estate Research

15 Note: All Spreads are quoted as "Spreads over Swap Rates"

# Interest – What Broke - AAA vs BB Spreads

<b>Greer CMBS / CMBx Yield Rate<sup>TM</sup></b>				
<b>Tranche</b>	<b>Yield</b>	<b>Suboord</b>	<b>Weight of Debt</b>	<b>Contribution to Total</b>
<b>AAA</b>	<b>2.72%</b>	<b>29.76%</b>	<b>70.24%</b>	<b>1.91%</b>
<b>AJ</b>	<b>3.59%</b>	<b>12.70%</b>	<b>17.06%</b>	<b>0.61%</b>
<b>AA</b>	<b>5.21%</b>	<b>10.63%</b>	<b>2.07%</b>	<b>0.11%</b>
<b>A</b>	<b>9.64%</b>	<b>8.00%</b>	<b>2.63%</b>	<b>0.25%</b>
<b>BBB</b>	<b>27.31%</b>	<b>4.72%</b>	<b>3.28%</b>	<b>0.90%</b>
<b>BBB-</b>	<b>28.65%</b>	<b>3.68%</b>	<b>1.04%</b>	<b>0.30%</b>
<b>BB</b>	<b>102.35%</b>	<b>2.69%</b>	<b>0.99%</b>	<b>1.01%</b>
<b>Unrated</b>	<b>176.00%</b>	<b>0.00%</b>	<b>2.69%</b>	<b>4.73%</b>
<b>Implied Overall Debt Yield</b>			<b>100.00%</b>	<b>9.82%</b>
<b>Loan to Value Ratio</b>				<b>75.00%</b>
<b>Class-A Equity Yield   Total Yield</b>			<b>29.00%</b>	<b>14.62%</b>
<b>Class-B Equity Yield   Total Yield</b>			<b>102.00%</b>	<b>32.87%</b>

Notes: ① The table is somewhat complicated, as evidenced by the numerous footnotes. Several conclusions can be drawn. 1) If the 'Implied Overall Debt Yield' is much greater than loan rates in the marketplace, the CMBS market CAN NOT recover because the required yields are too high to make debt affordable to borrowers. 2) When the spread between AAA and BB tranches is above 500 bps (now at 9,963 bps), the market can't recover because of risk aversion for lower-rated tranches. As a point of reference, January '07 AAA-BB CMBS spreads were around 65 bps. Lastly, the yields for each tranche provide tremendous insight into the required yields for each layer in the capital stack.

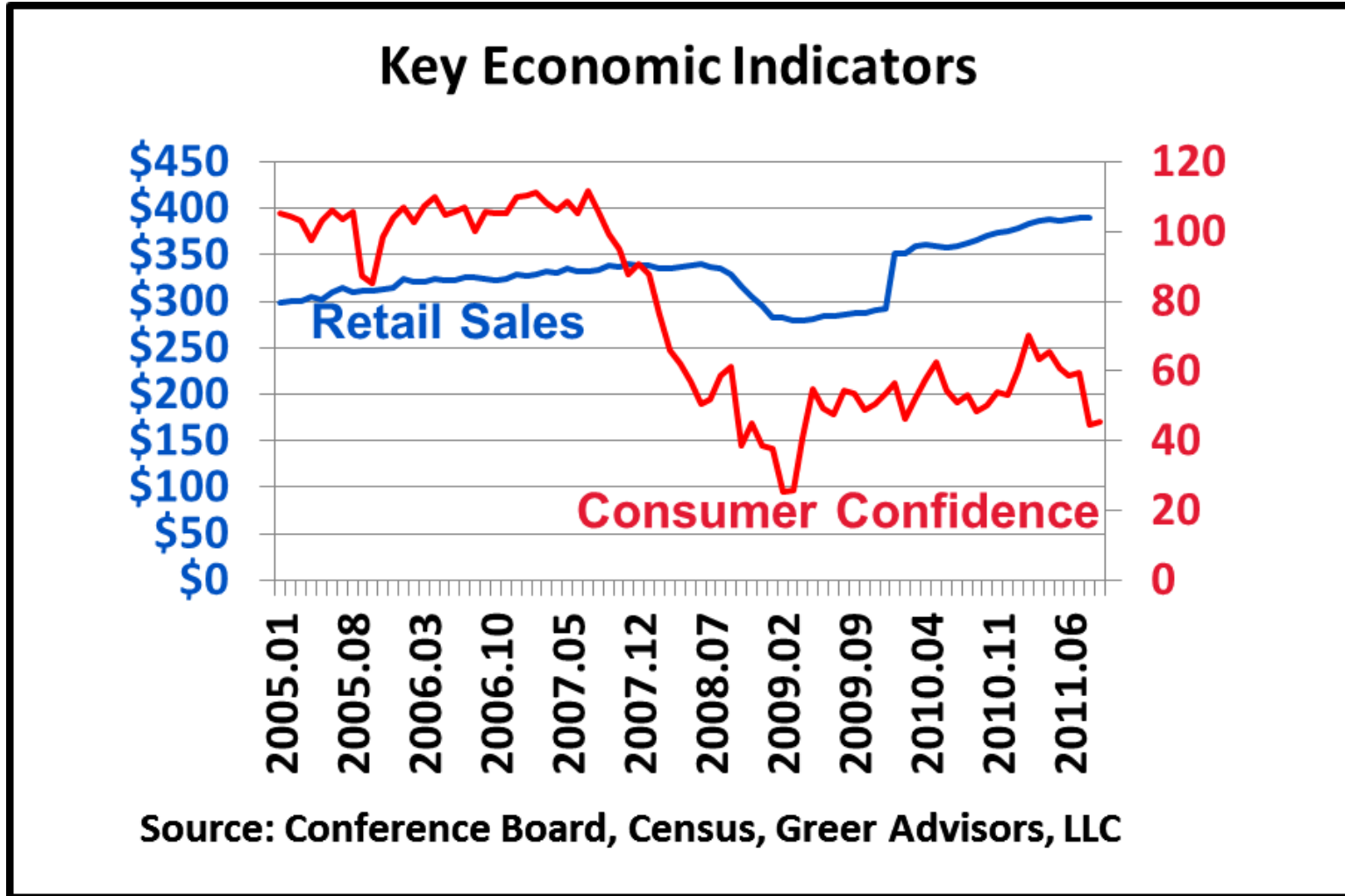
② Markit<sup>TM</sup> Data and Calculations based on close of 10/12. Swap (10Yr) as of 10/11.

③ Coupon and Price data were from Markit<sup>TM</sup> for AAA Senior through BB bonds. Markit<sup>TM</sup> data was used as part of the calculations by Greer Advisors, LLC to determine Spreads. Subordination levels were from Markit<sup>TM</sup>.

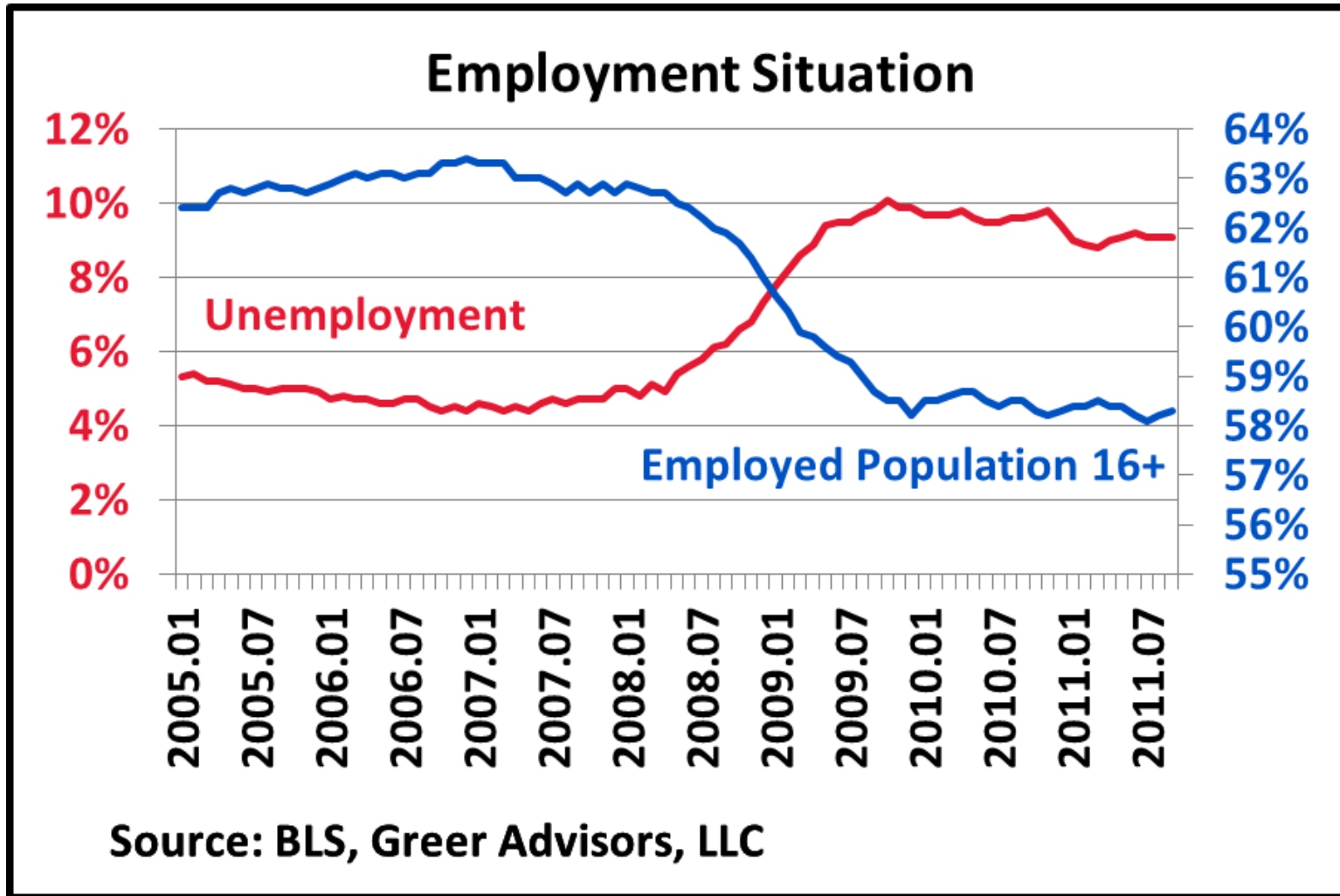
④ Profit / arbitrage opportunity for the issuer was ignored.

⑤ The yield spread for "unrated" classes were based on (BBB-yield minus BB yield) times 1.0, round to the nearest bp. Class-A property equity yield was assumed equal to the BBB- (last investment-grade piece) yield rounded to the nearest 100 bp. Class B property equity yield was assumed equal to the BB yield, rounded to 100 bps.

# Economy – Consumer Confidence & Sales



# Economy – Employment





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# Economy

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## **Consumer Side**

- Consumer Confidence is Poor at 45.4 (9/27/2011 Conf. Bd.)
- Unemployment Remains High 9.1% (Sept. 2011 – BLS)
- Potential Sovereign Defaults (PIGS)
- Liquidity, Leverage, Interest (for non-AAA Debt) – Poor
- Retail Sales are OK, the Rest is near Flat Line

## **Investment Banks**

- Capital IQ and Deal Logic show LBO's /M&A on the rise
- Record Profits – GS near 1,000 batting average every day since the Crisis Started
- IB's record profits – cost of taxpayer

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# Financial Regulations

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## **Dodd-Frank Wall Street Reform & Consumer Protection Act**

- 16 Titles – See Summary on Wikipedia
  - 243 Rules to be created (reportedly 62% not done)
  - 67 Studies required (most are not done)
  - 22 New Periodic Reports
- Restructure of Regulators, elimination of OTS
  - Financial Stability Oversight Council (New)
  - Office of Financial Research (New)
- Keys for Commercial Real Estate:
  - Rating Agency Reform
  - Securitization Reform (nominal change due to QIB clawbacks)
  - Derivatives – minimal change thus far due to “netting”

# Investment Banking

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## **Advise Companies, High Net Worth Organizations/Individuals**

- Collect Fees on Products, and Services

## **Structure Deals (Structured Finance) – Bonds, Stock, etc**

- IPOs, Raise Equity, M&A
- Municipal Debt, CFDs, REITs, MBS, CMBS

## **Creation and Sale of New “Cash-Less Deals” (aka Derivatives)**

- Options, Calls, Puts, Covered, Naked
- Futures Indexes, Commodities (Oil, Metals, Grains, Animals, etc)
- Swaps – Interest, Currency, Credit Default, Life/Longevity

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# Investment Banking – Derivatives - Volker

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## **Derivatives can be used as a Hedge**

- Oil Consumer buys Futures Contract to Lock in Price
- Holder of Stock Buys Put Contract as Insurance against Loss
- Borrower with Variable Rate Loan buys Interest Swap
- Buyer of Bonds buys CDS “like” Credit Insurance
- Corporation Buys Death Swap on Board of Directors

## **What is the IB’s Role?**

- Are they Hedging an Existing Position or merely Placing a Bet
- Are they a Market Maker on the underlying instrument or derivative?
- If they sell two sides of a Swap, do they have risk?

# What is CDS?

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## Credit Default Swap

- A bilateral contract where two parties agree to trade the credit risk of a third-party. A protection buyer pays a periodic fee to a protection seller in exchange for a contingent payment by the seller upon a default or failure to pay. Once triggered, the seller either takes delivery of the collateral (eg bond, note) or pays the buyer the difference between the par value and recovery value of the bond (cash settlement).
- They resemble an insurance policy, as they can be used by debt owners to hedge against credit events.
- Warren Buffet called **ED** these “Weapons of Mass Destruction”
- .....counterparty???

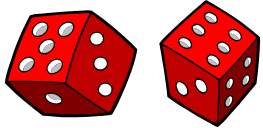
# Players in “Simple” CDS

## Business Issues Bonds

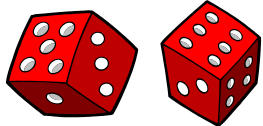


Bonds initially rated too poor for market, eg “BB”

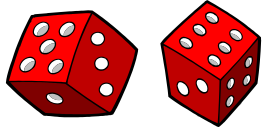
Side Bet 1



Side Bet 2



Side Bet 3

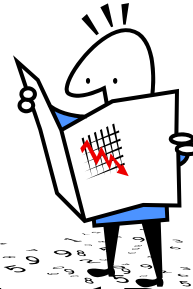


Investment Bank issues CDS (aka Credit Enhances Debt) Enough to make BB = AA, if debtor fails, IB buys bonds

## Rating Agency Rates Bonds



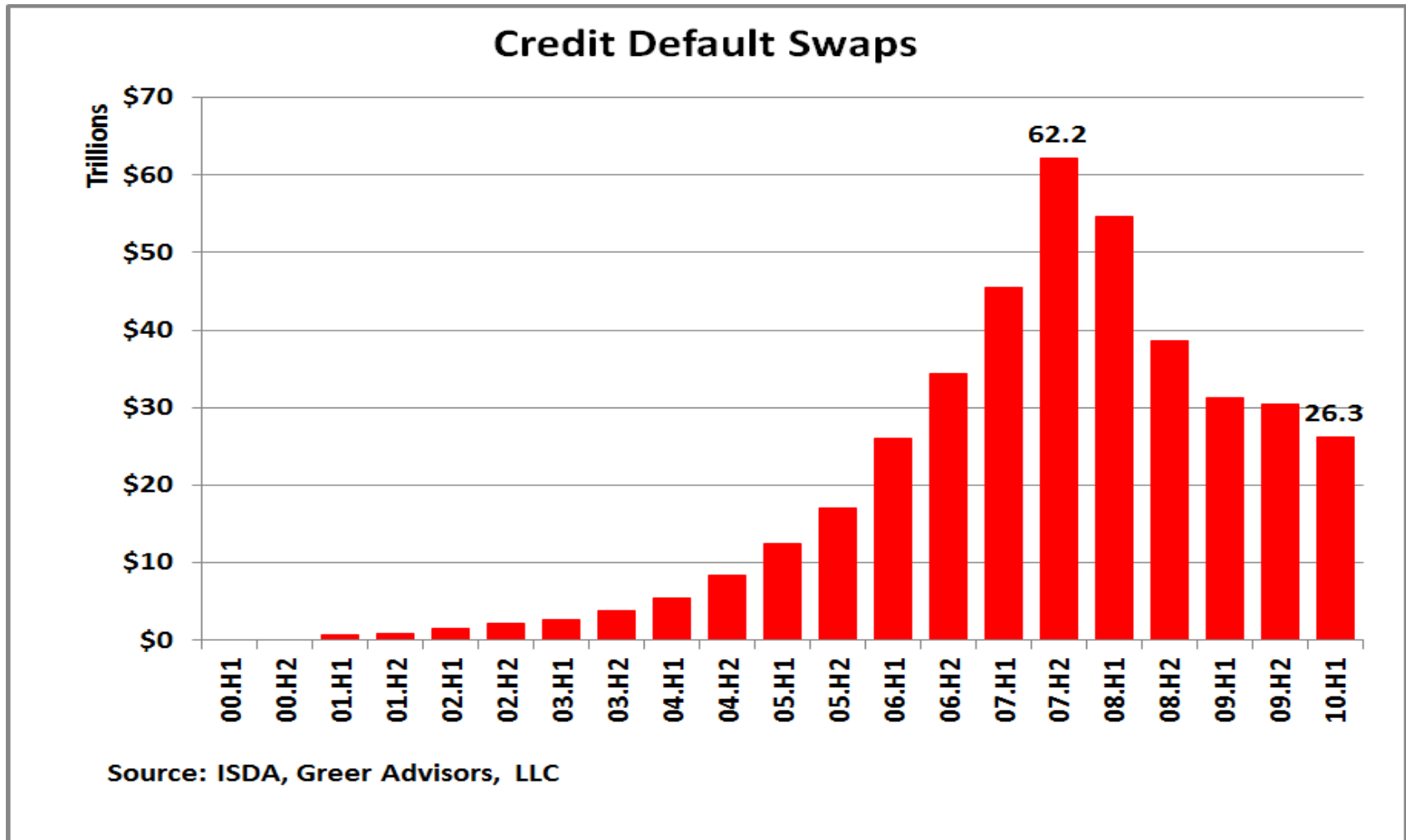
Gives loss forecast & amount required for “AA” rating



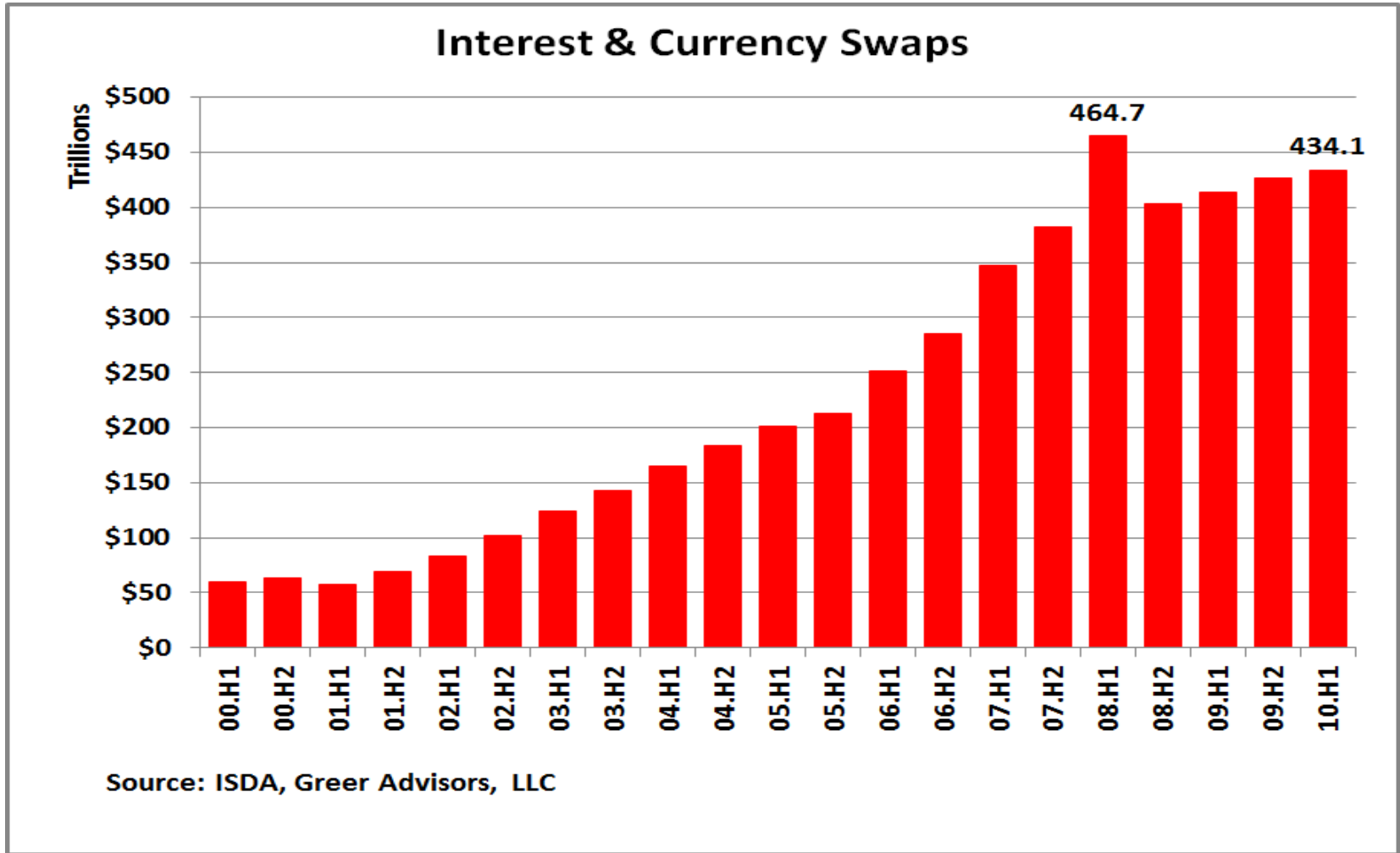
Pension Fund Buys Bonds with CDS enhancement  
Thinks it's AA investment

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# Credit Default Swaps



# Interest & Currency Swaps



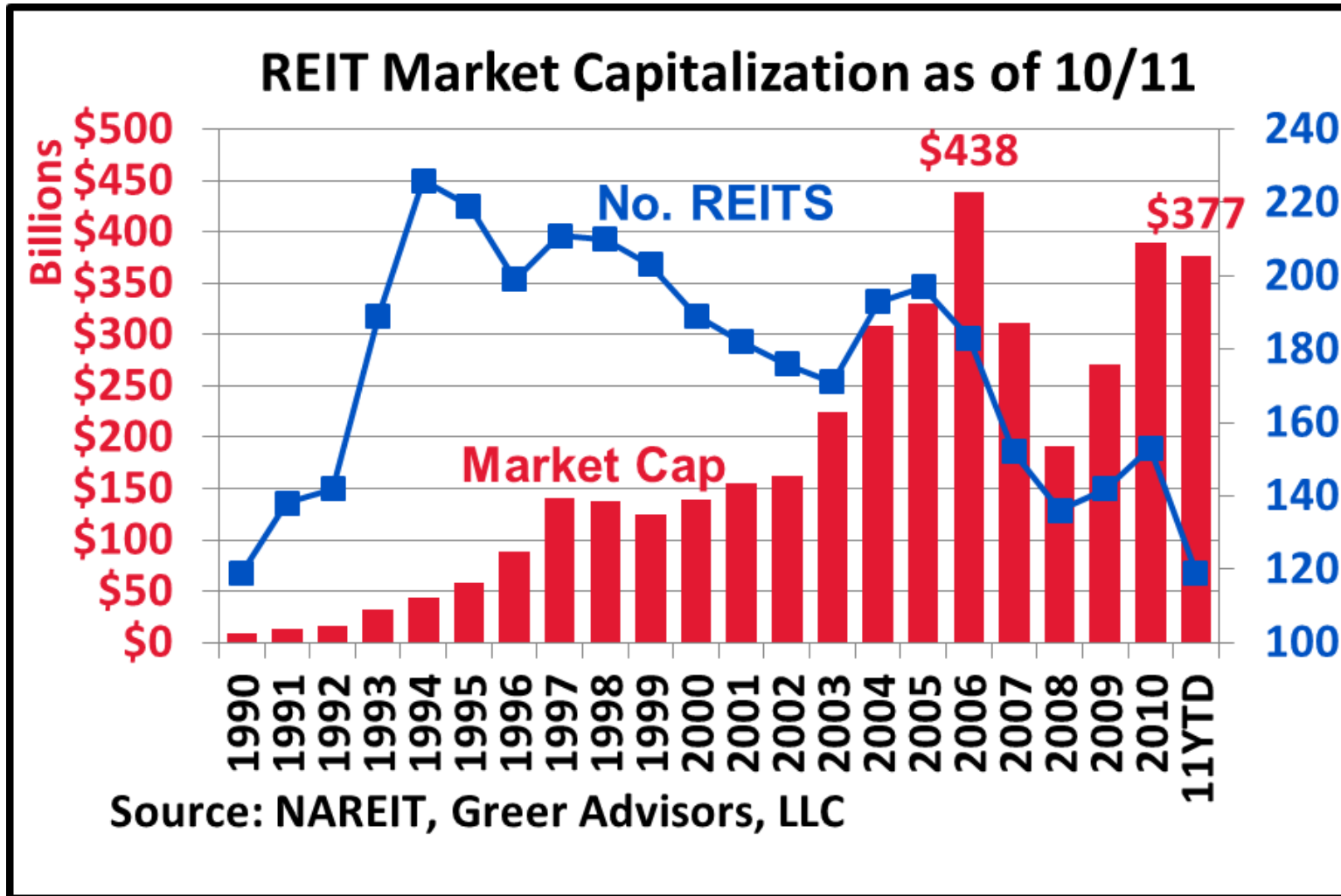


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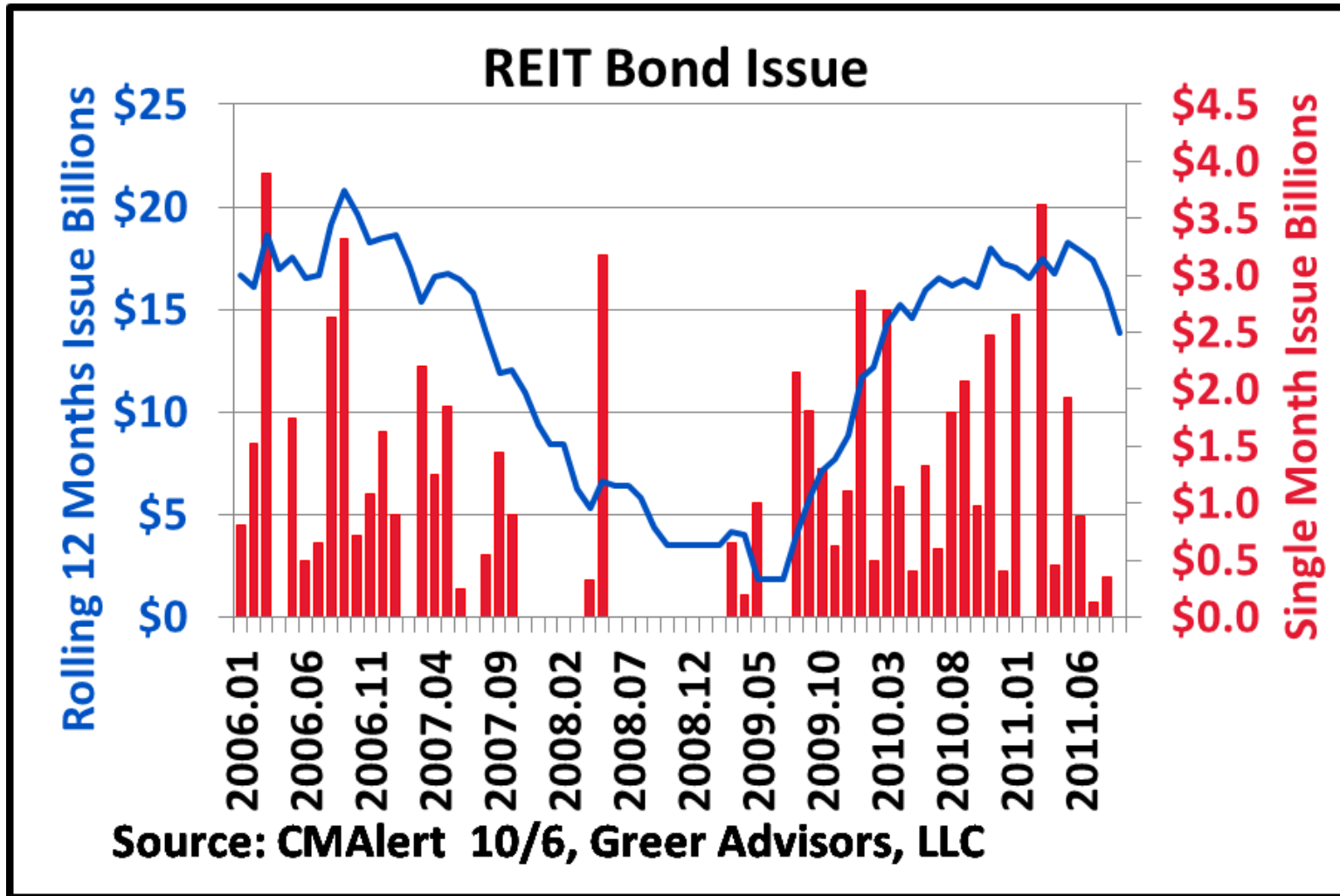
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- Real Estate Capital Markets

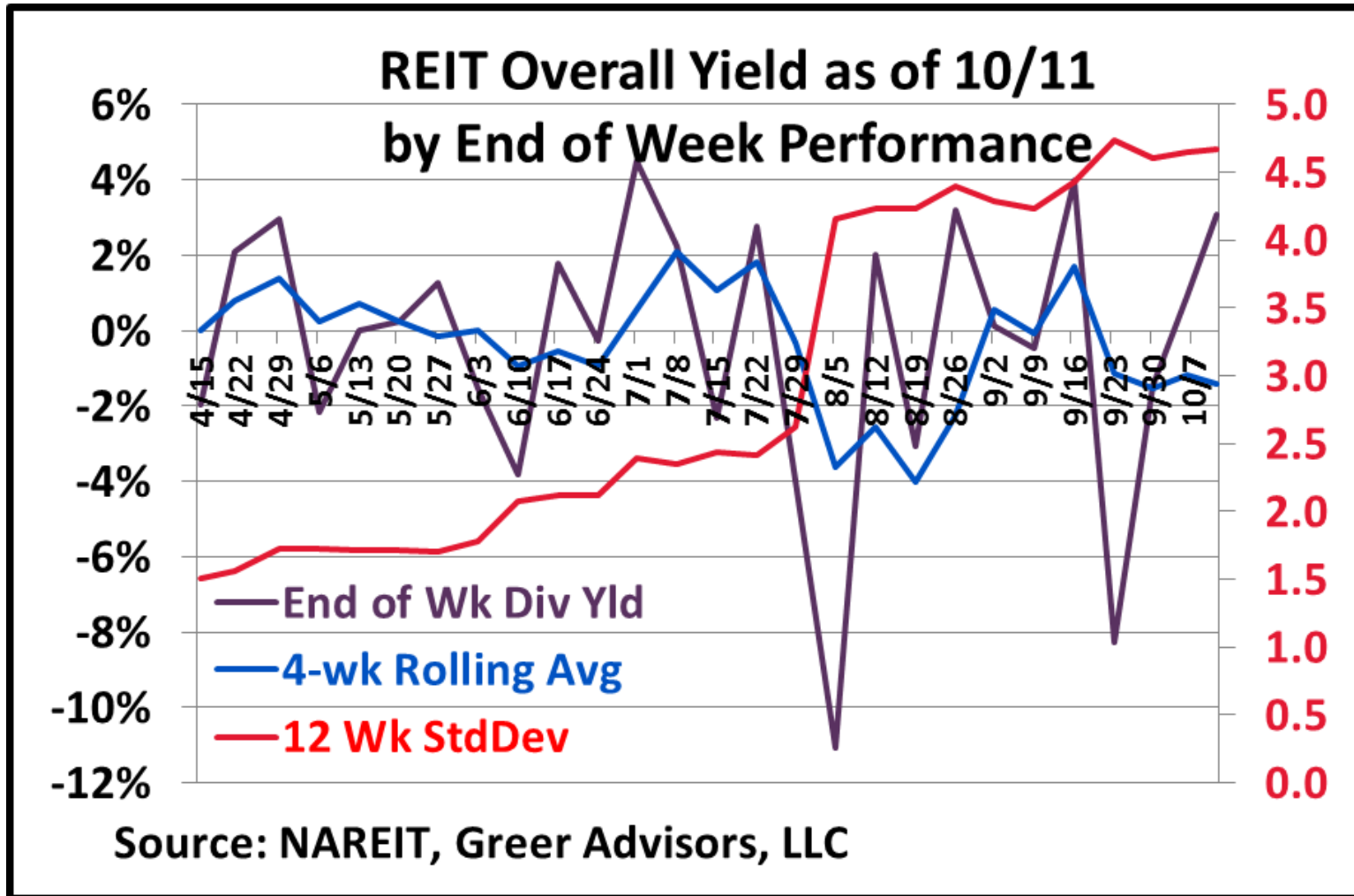
# REIT Market Capitalization



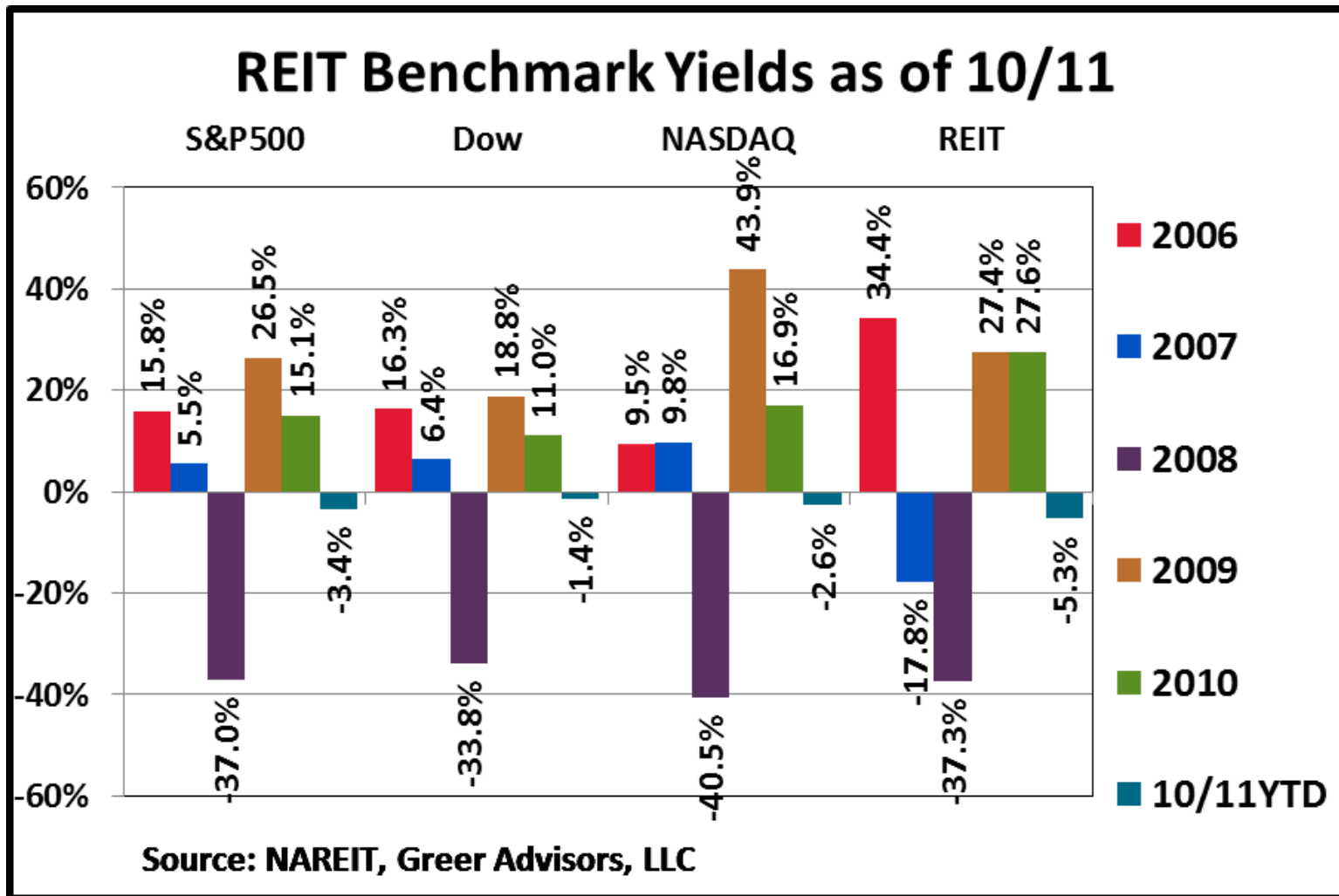
# Overall REIT Dividend Yields – Stable?



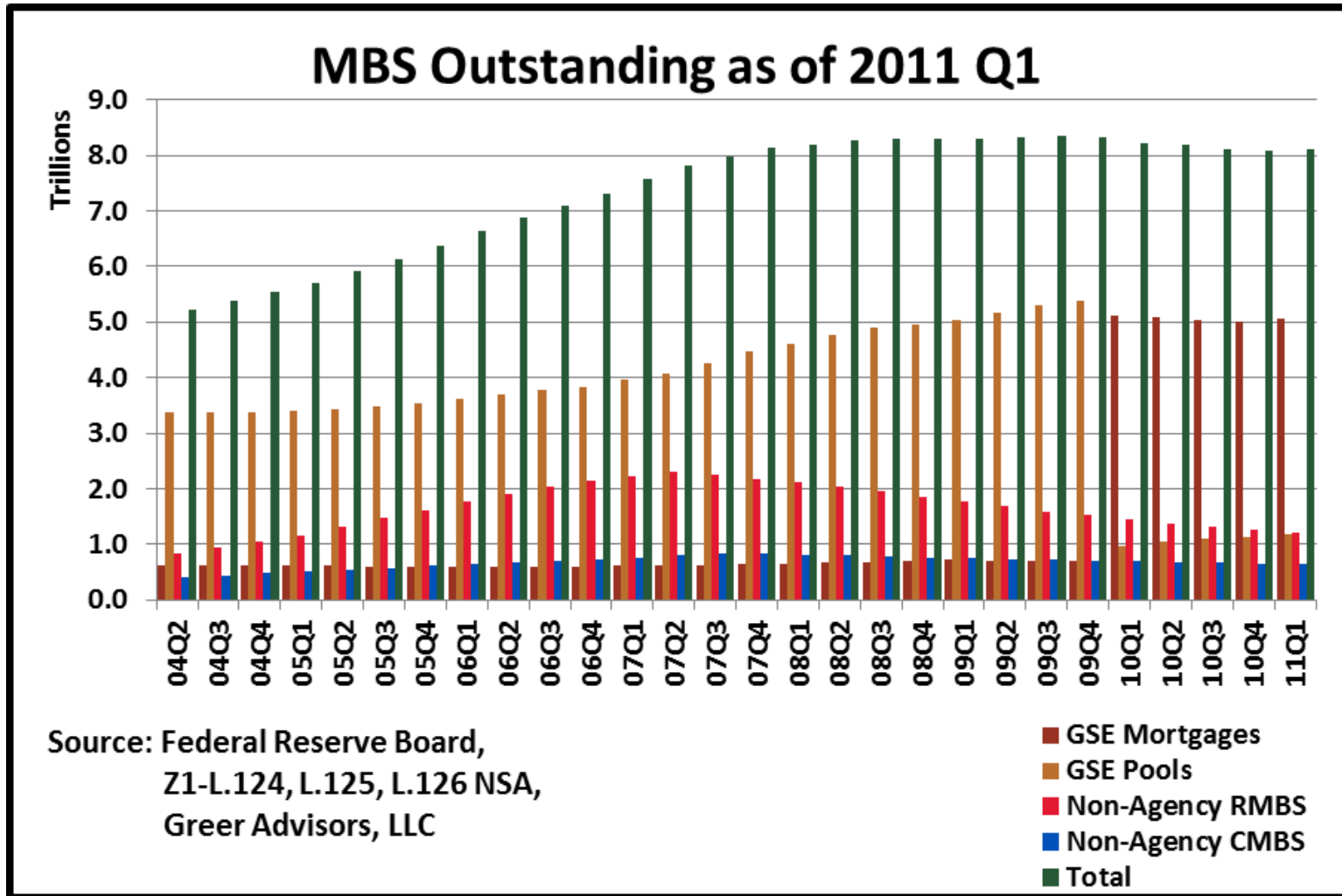
# Overall REIT Dividend Yields – Stable?



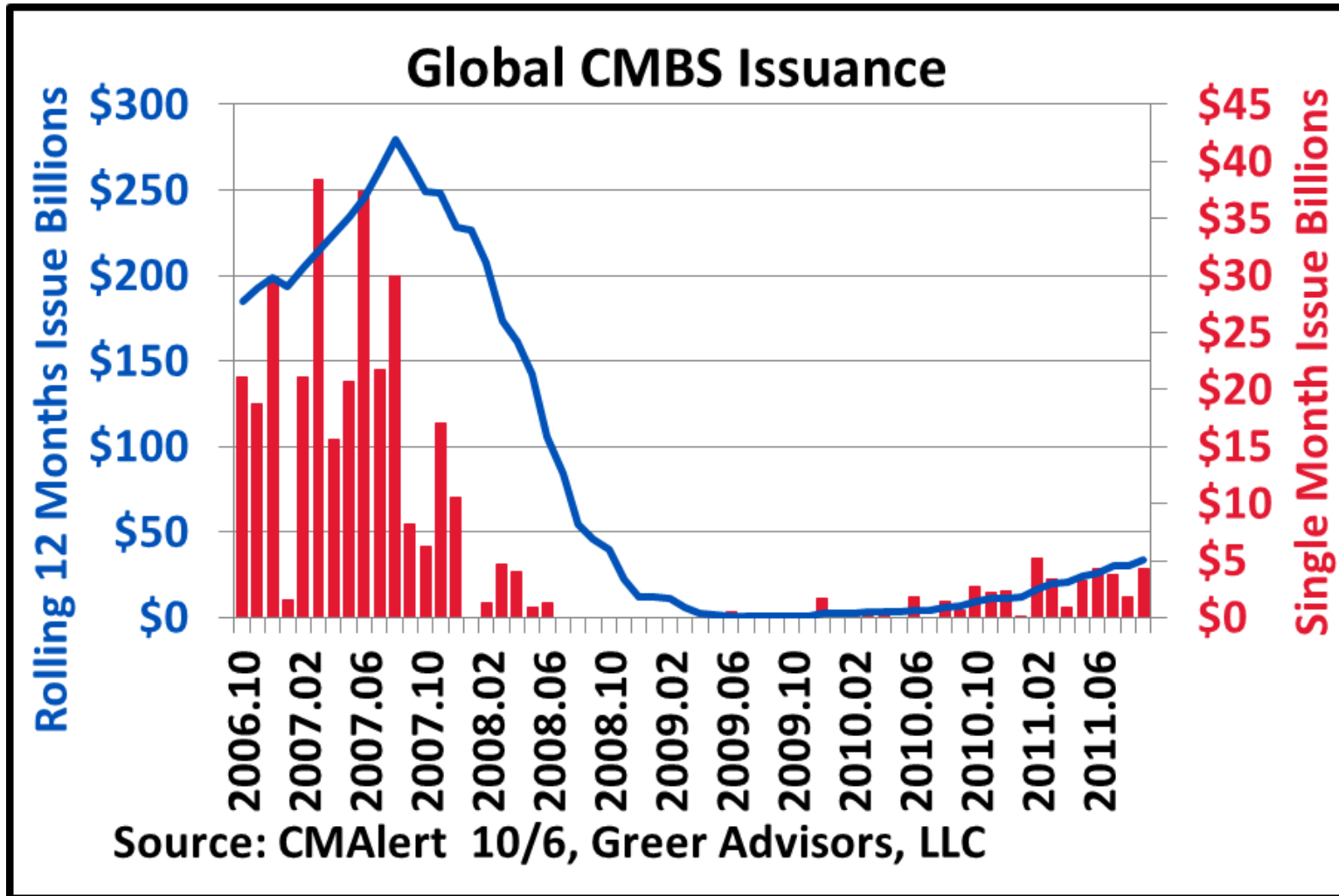
# Overall REIT Dividend Yields – Stable?



# MBS Outstanding's in U.S. - Dropping



# Global CMBS Issuance – Not Recovered



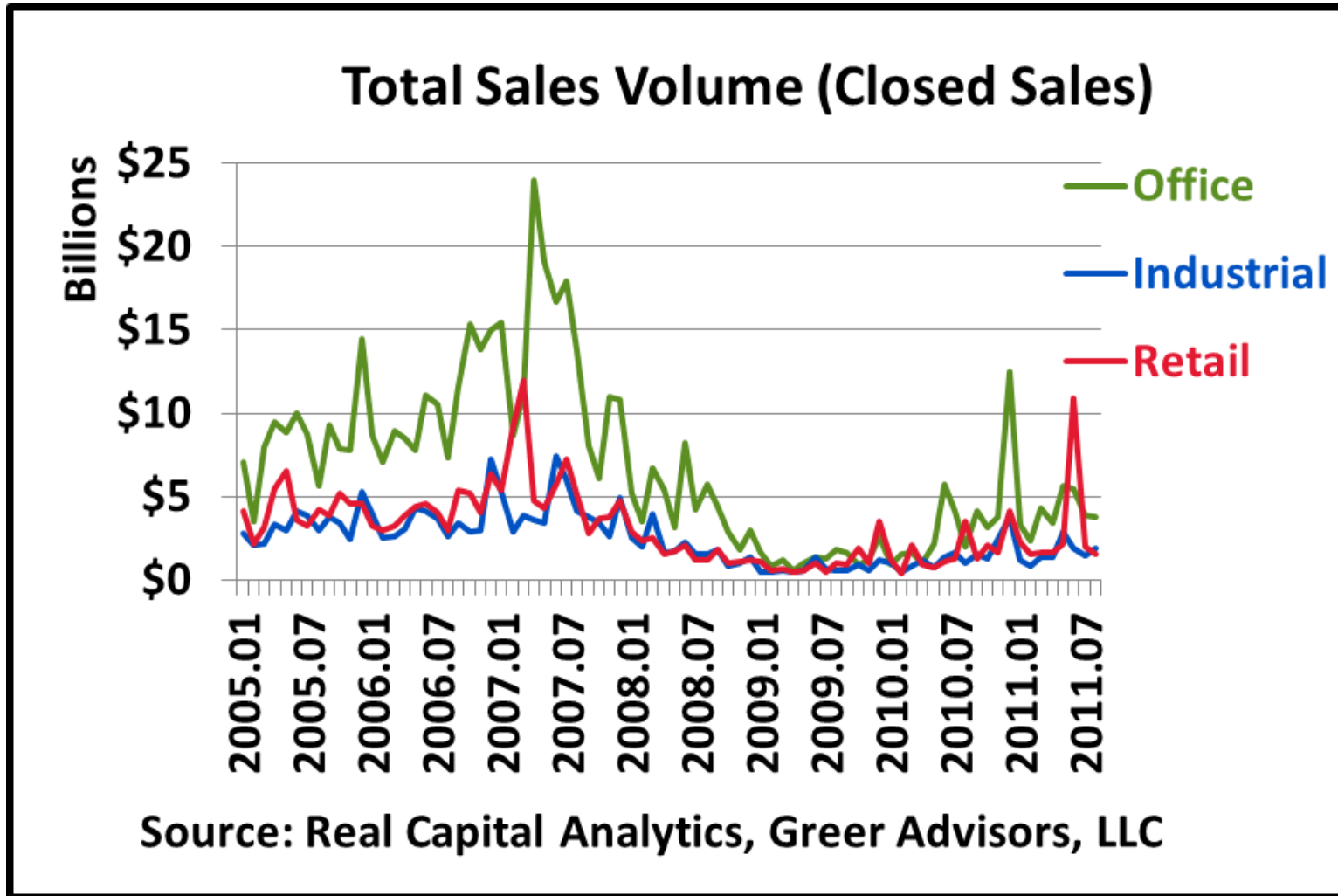
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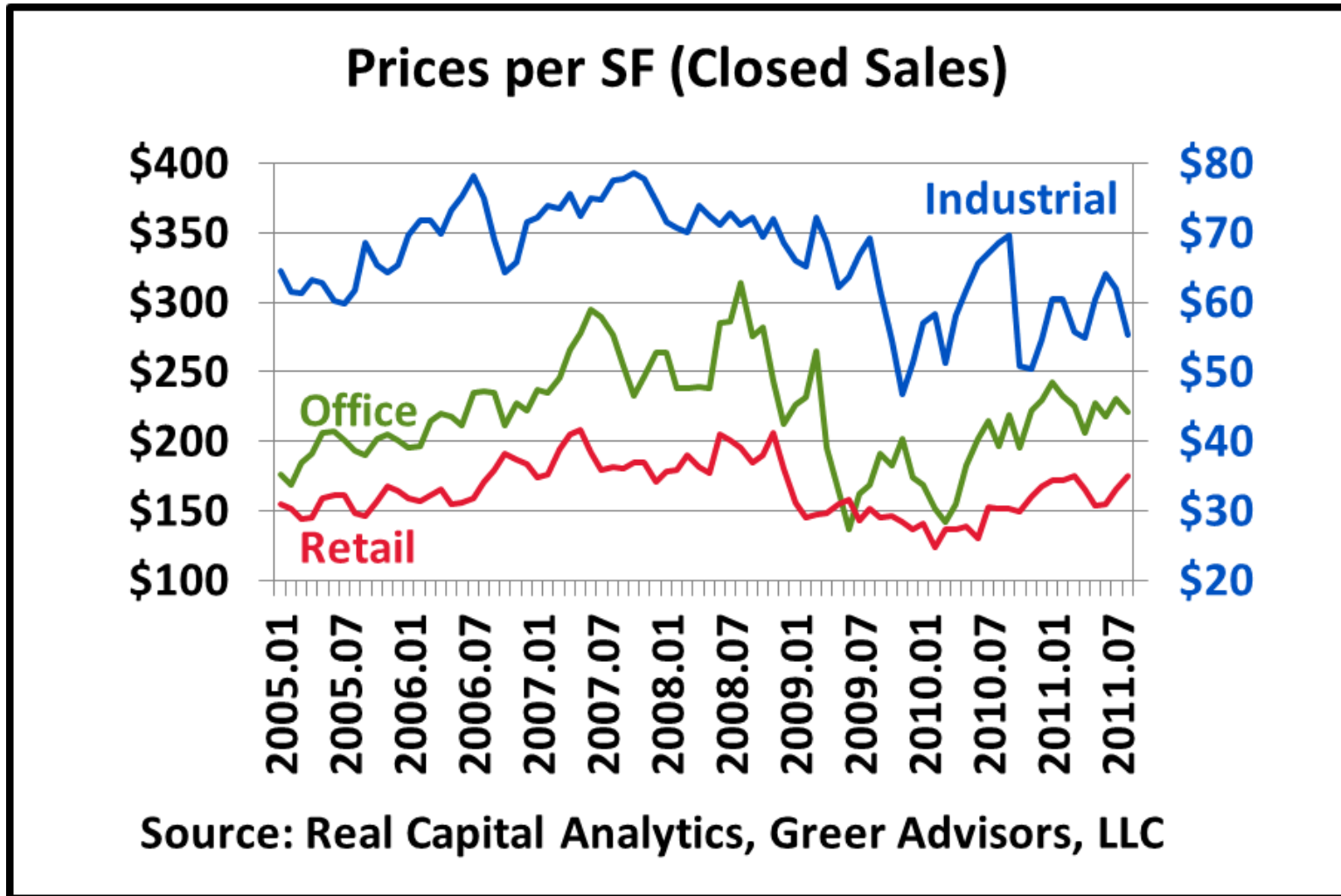
- Real Estate Markets



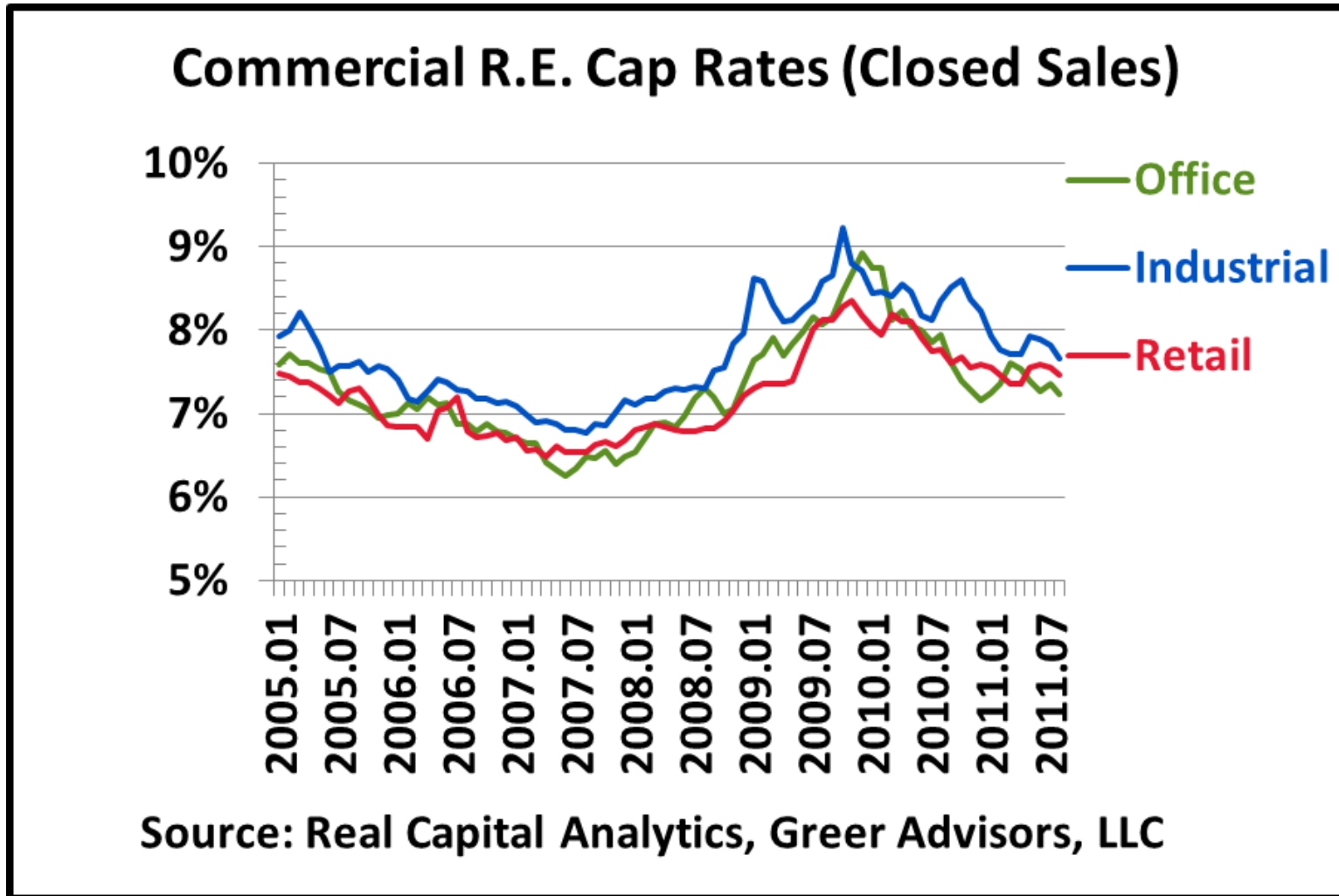
# Commercial Real Estate Sales Volume



# Commercial Real Estate Prices \$\$ PSF



# Commercial Real Estate Cap Rates



# Future - Mortgage Backed Security

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- If NSROs don't "**Get It**" Feds should replace them
- 'Til MBS Returns, Real Estate markets **WILL NOT** recover
- Most banks ARE NOT in the business of holding debt
- New MBS WILL EMERGE with terms as follows
  - No "quick buck" investment banks/mortgage bankers
  - Issuer holds 1-5% of pool as "1<sup>st</sup> Loss / Good Faith" position
  - 60-80% of pool will be AAA, not 90+%
  - Buyers of paper will "re-underwrite" pools, regardless of

# Future of Banking

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**Investment Banking Rules (Volker / Dodd Frank) will Impact Commercial Real Estate**

**Past Three Years have Shown largest lending decline in history - see FDIC QBP**

**CMBS Loss Rates – Still All Time Highs, Banks better**

**Separation of “Best of Best” Class A vs. Class B/C**

**Deleverage – Expect More for Class B/C**

**More Restrictive Covenants for REITs, CMBS**

**“R” word for Loans (recourse)**

# Top - Bottom Market Stats – as of 2011 Q2\*

INDUSTRIAL - 2011.Q2				OFFICE - 2011.Q2				RETAIL - 2011.Q1				
Metro	Vac %	Eff Rent \$		Vac	Metro	Vac %	Eff Rent \$	Vac	Metro	Vac %	Eff Rent \$	
Los Angeles	7.3%	\$6.68		1	Honolulu	7.9%	\$21.99		1	San Francisco	3.6%	\$29.89
Salt Lake City	8.4%	\$4.86		2	Albany	8.4%	\$14.94		2	Fairfield County	4.3%	\$25.26
San Francisco	10.1%	\$7.87		3	New York	8.9%	\$55.26		3	Long Island	5.4%	\$22.75
Houston	10.4%	\$5.59		4	Pittsburgh	10.6%	\$17.80		4	Northern New Jer	5.4%	\$24.52
Orange County	10.4%	\$8.13		5	Long Island	11.9%	\$19.88		5	San Jose	6.0%	\$26.68
Portland	10.6%	\$6.19		6	San Francisco	12.0%	\$22.25		6	Los Angeles	6.2%	\$25.15
Kansas City	10.7%	\$6.49		7	Trenton	12.5%	\$24.50		7	Orange County	6.2%	\$26.56
Long Island	11.2%	\$5.45		8	Oklahoma City	12.7%	\$14.66		8	Oakland-East Bay	6.3%	\$24.88
<b>National Average</b>	<b>12.8%</b>	<b>\$5.27</b>		<b>National Average</b>		<b>15.7%</b>	<b>\$20.65</b>		<b>National Average</b>	<b>10.4%</b>	<b>\$16.47</b>	
<b>Min</b>	<b>7.3%</b>	<b>\$2.77</b>		<b>Min</b>		<b>7.9%</b>	<b>\$14.46</b>		<b>Min</b>	<b>3.6%</b>	<b>\$9.93</b>	
<b>Max</b>	<b>15.5%</b>	<b>\$8.13</b>		<b>Max</b>		<b>19.1%</b>	<b>\$55.26</b>		<b>Max</b>	<b>14.4%</b>	<b>\$31.94</b>	
<b>Spread</b>	<b>8.2%</b>	<b>\$5.36</b>		<b>Spread</b>		<b>11.2%</b>	<b>\$40.80</b>		<b>Spread</b>	<b>10.8%</b>	<b>\$22.01</b>	
Source: CBRE Economic Advisors, Greer Advisors, LLC				Source: CBRE Economic Advisors, Greer Advisors, LLC				Source: REIS, Greer Advisors, LLC				

Source: CBRE Econometric Advisors,  
Greer Advisors, LLC, \*Ret=Q1

# Conclusions

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- CASH IS KING!
- Class A vs. B/C Big Cap Rate Spreads
- Reduced Leverage for ALL Investor Deals
- SBA will remain Only Source for High Leverage
- MBS – Very Slow Return. Need New Business Model
- Insurance Co's, Fannie/Freddie and Some Lenders are Active
- Rents / Vacancies Remain better than early 1990s
- Real Estate Cost is **NOT** the Largest Cost of Business!!!

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# Quote of the Day

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“...prediction is very difficult, especially when it’s about the future...”

~~NY Yankees #8, Yogi Bera~~

Niels Bohr

Nobel Laureate, 1922

Atomic Structure /

Quantum Mechanics





# Greer's 3-Year Forecast as of 10/13/2011

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- Barbell Modest Growth or Global Recession
  - Global Economy Heals or Not
- Cap Rates will Rise 0.5-2% during 2011-13
  - Mostly in class B/C
  - Trophy Class A will remain low until Flight to Quality Stops
- Margins (to 10 Yr Treasuries or LIBOR) will rise and settle at 300±50 bps over 10 year Treasuries, but might over-correct in the short run, say 10Yr 400+ bps.
- Values have recovered slightly.
- Individual Market Performance will continue to vary widely.
  - 10-30% difference in Top vs Bottom
- Change Creates Opportunities – Build Businesses
- SBA will Continue

# Greer's Recovery Signs – Prereq's to Recovery

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- $\sqrt$ CDS Exposure under \$25 Trillion (i.e. under 50% of peak)
- $\sqrt$  Stable or Decline in CMBx Yield Spreads for 6 weeks
- Re-emergence of CMBS market
  - New CMBS Market will include:
    - Issuer Keeps 1-5% 1<sup>st</sup>-loss piece
    - AAA Subordination near 30%....
    - AAA is 70%, not 90% of issue
- $\sqrt$  REIT Market Capitalization (Total Value) Stabilizes or Increases for 6 months
- Consumer Confidence Rises and Stays Above 70 for 6 months
  - As of 9/28/11 (last report) index at 58.5 (1985=100)
- Risk Curve (AAA Sr. vs BB) flattens to under 500 bps. As of 10/12/11, CMBx spread stands nearly 100 pts (2.72 v 102.35) or 10,000 bps

# Questions / Answers

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