

## **“Professor’s Comments”**

(For the November 2009 Moody’s/REAL Index returns.)

*This is a periodic commentary which will generally be posted monthly on the “RealIndices” web site, offering the perspective on the indexes of Professor David Geltner (or occasional guest commentators). Geltner was a leader of the team at MIT that developed the methodology for the Moody’s/REAL Indexes.*

## **Finally a Positive Month!**

Yea!... After 13 straight negative months the CPPI has finally turned in a positive number. While November was only +1%, we’ll take it! (Hey, if that rate keeps up for a year we’ll post a 12% gain by the end of 2010...) In fact, while from a quantitative perspective this one month may be more symbolic than substantive, I do think it is significant. Of course, it does not necessarily mean that the price index has reached its final cyclical bottom (although that is a possibility), but in combination with other evidence November’s positive CPPI return strongly suggests that we are essentially in “bottom territory”. I would not be surprised if we still see some more negative months for a while. But these may well be more in the nature of “bouncing along the bottom”, interspersed with positive months, rather than any further substantial secular decline in realized prices. Let’s peak behind the headline number to take a more in-depth look...

## **Implications in the Volume & Distress Numbers...**

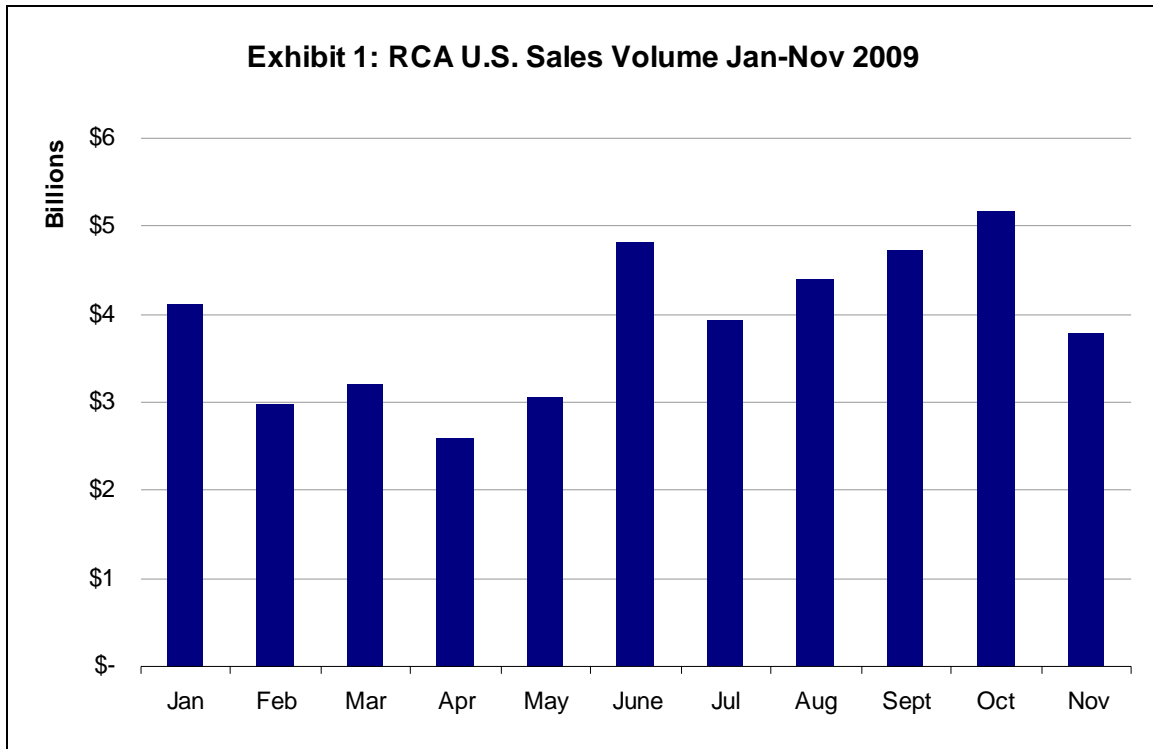
To feel really bullish about the November price uptick, we would like to see it accompanied by some other relevant indications, such as growing sales volume, and ideally an upturn in the pricing of distressed assets, which are the potential big drag on the market. Unfortunately, we don’t quite see strong positive evidence in these other dimensions as yet, although the signals are mixed and nuanced.

Take the volume numbers for example. Exhibit 1 on the next page charts the RCA transaction volume by month during 2009. November’s \$3.8 billion was noticeably below October’s \$5.2 billion. But November is typically an “off month” in U.S. real estate sales closings, and yet its volume was clearly above the levels of last spring. Furthermore, December volume looks to be up strongly (not shown in the chart), with the value of closings reported by early January already exceeding that of any other month in 2009. However, some of that December volume may be an end-of-year effect.\* What we can at least say is that November 2009 sales volume was less far below November 2008 than any other 2009 month’s year-over-year sales decline. Indeed, November’s 27% RCA sales decline compared to the previous November was the lowest year-over-year

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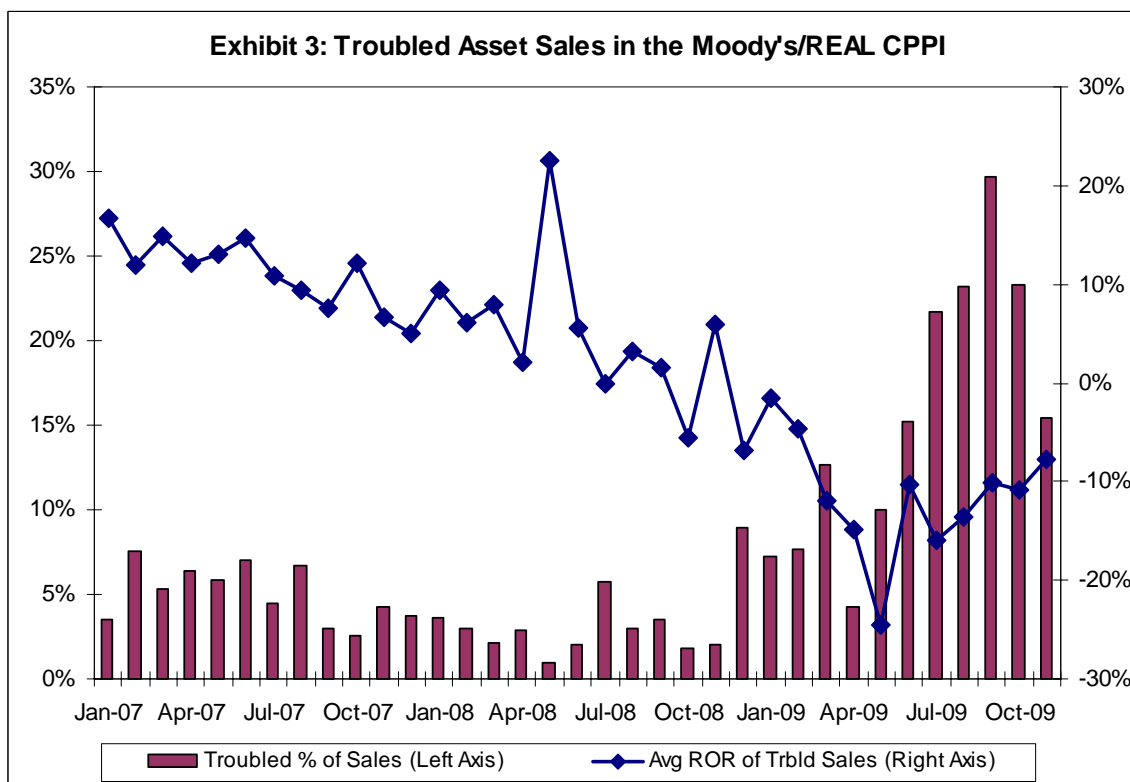
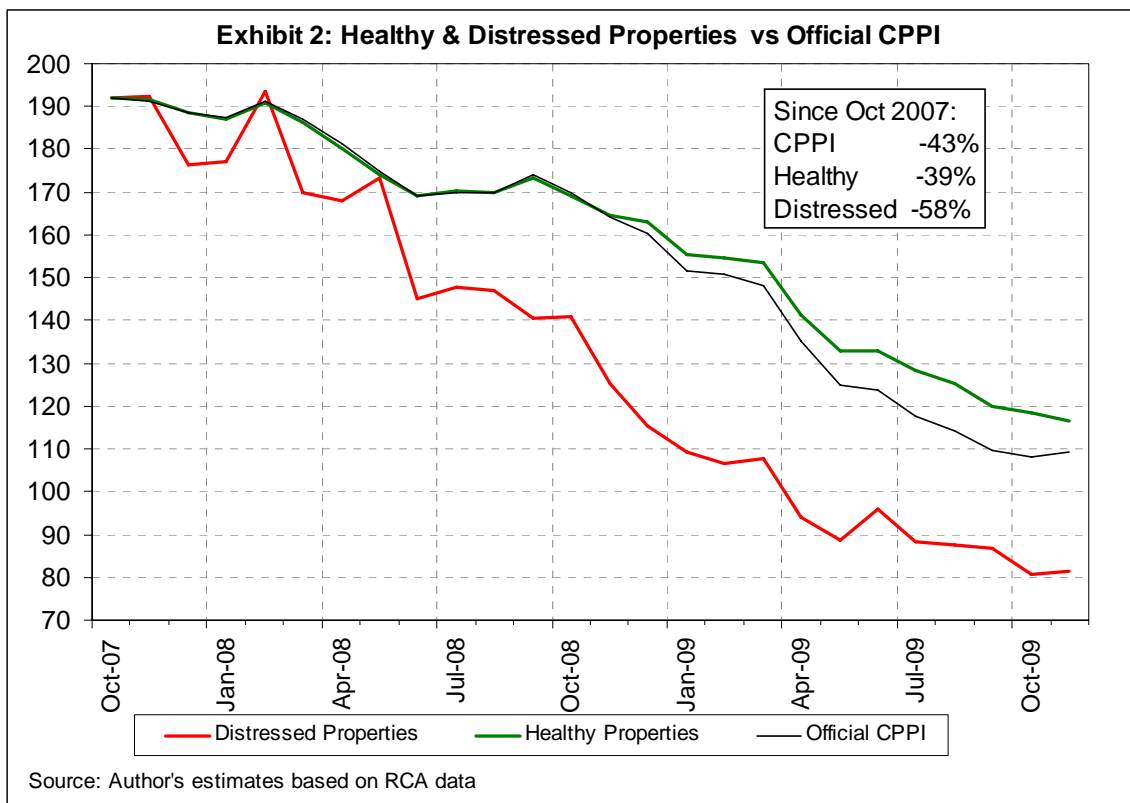
\* Normally a strong increase in volume would suggest that December is likely to be another positive month in the price index. However, if the end-of-year effect includes a big batch of distressed property sales, then that could conceivably drive the index down again. So far, this does not look to be the case, however.

volume decline since the credit crunch began in late 2007. And November is the second month in a row in which we can make such a statement. So, while the overall trading volume numbers are certainly not bullish, they are also not inconsistent with a price bottom or floor.



Next consider the evolution of the “bifurcated market” and the indications regarding distressed sales in the CPPI. Exhibit 2 updates our break-out of the CPPI between “distressed” sales (i.e., second sale flagged by RCA as a “troubled” asset) versus “healthy” property sales (which only means they are not tagged with the RCA “troubled asset” flag). Pegged to the CPPI October 2007 peak price level of 192, healthy property prices are down to 117 while properties falling into distress since the peak are holding around 83. Perhaps the most powerful indicator we could see that would suggest a strong price bottom (or even upturn), would be if the distressed sales pricing would turn up, ideally together with an increase in distressed sales volume. This would indicate that the vultures with their \$100+ billion cash hoard earning near zilch would be beginning to fight with each other for deals. But we don’t yet see this, perhaps not surprisingly. There is a very slight uptick in distressed asset pricing (+1.2%, too small to be significant), but distressed sales volume was actually down slightly in November, although Exhibit 2 does suggest a leveling out over the past several months in the distressed asset pricing.

Exhibit 3 shows that distressed sales as a percentage of the CPPI repeat-sales observations has fallen for two months in a row, down to about 15% of the repeat-sales used to compute the index. This drop in the weight of distressed sales is no doubt partly responsible for the positive CPPI result in November. But what does that say about what is going on in the market?... Consider also the achieved price-change rates of return in the



troubled asset sales in the index, tracked on the right-hand axis in Exhibit 3. This shows that the November distressed sales in the CPPI on average had an annualized price-change of negative 8% (lifetime over their investment holding, from buy to sell). While that is of course a painful investment result, it is a strong improvement from the nadir last May of negative 25%, and continues a clear multi-month upward trend in distressed-sales performance in the CPPI. Indeed, distressed sales annualized lifetime price-change performance is not now too far below the average price-change result among the “healthy” property sales, which was negative one percent per annum in November.

What all of this points to, I believe, is the crucial role that the *rate* and *nature* of distressed selling is playing, and likely will continue to play over the coming year, in the U.S. commercial property market. And this, in turn, points to the important role of Government policy in the market.\* The pattern that has emerged in late 2009 is that distressed selling is holding very orderly. It is not panic selling, and it is not excessive in volume. In part due to assistance from Government policy, and in part no doubt as a result of private institutions recalling the lessons from the mid-1990s, owners of distressed properties on the supply side of the market are finding ways to avoid large-scale “fire-sales” of troubled assets, so far. This is preventing commercial property prices as tracked by the CPPI from falling much further, from falling into what I have labeled “negative bubble” territory (as commercial property prices have done in past down cycles).

This pattern of restrained distressed selling is helping to establish at least a tentative bottom or floor in the market pricing. However, it is also preventing sales volume from recovering as much or as fast as it otherwise could. And it may make it more difficult for a substantial positive price bounce-back to occur (as occurred after the troughs in past cycles in the 1970s and 1990s). This is because the inventory of distressed assets keeps accumulating (to over \$160 billion by late 2009), and because potential buyers can foresee that \$80 billion worth of 2006-08 vintage CMBS loans will mature in 2011-12, with another even larger wave of \$260 billion worth of such vintage loans maturing down the road in 2016-17. In general it is more difficult for CMBS conduit loans to play the “extend and pretend” game than portfolio mortgages.

Thus, things are precariously balanced. If the economy continues to improve, and if distressed selling continues to be orderly and controlled, then I feel confident the CPPI has found its bottom (though it may bounce along slightly up or down from month to month). If the supply side of the market continues to maintain its discipline and the vultures grow tired of holding cash at historically low yields, then we could actually get a modest positive bounce, especially if the economy comes back more strongly than anticipated. If on the other hand the economy weakens again, and/or the weight of distressed assets becomes too massive to hold back triggering large-scale fire-sales, then the CPPI could move down again and indeed into a “negative bubble”. This drama will play out largely over the course of 2010 and perhaps into 2011.

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\* Other recent reports have noted this same point. See for example Bob White’s essay in the recent PWC-Korpacz “Real Estate Investor Survey”.

## Geographical perspectives on the CPPI...

Now, just for fun, let's continue an exploration that I started in last month's commentary, when I showed a CPPI break-out based on a simple definition of supply-constrained versus unconstrained markets. I think geographic break-outs of all-property aggregate price indices are fascinating, because I think that in some ways geography is the essence of real estate as an asset class. Certainly at the physical level, the defining characteristic of real estate assets is that they are fixed in location. But they are not necessarily fixed in usage type. When you own a property, you typically own the land, which you cannot move, but you can change the usage type of the structure. By aggregating across the property usage type sectors, we sharpen the analytical focus onto the geographical dimension, onto the underlying land value or location value dynamics.\*

With this in mind, have a look at Exhibits 4 and 5 on the following page. (The exhibits have the same vertical scale, and are summarized statistically in the table below.) These two exhibits present two alternative 4-way break-outs of the CPPI by geography. Both exhibits present "all-property" indices that include all the four core property usage types aggregated: Apartment, Industrial, Office, and Retail. Exhibit 4 is based on the traditional contiguous four NCREIF multi-state regions: East, South, West, and Midwest. Exhibit 5 is based on non-contiguous geographic definitions that correspond more directly to basic urban economic dimensions: Central Business District (CBD) versus non-CBD, and Supply-constrained ("SupCon") versus Non-constrained markets.†

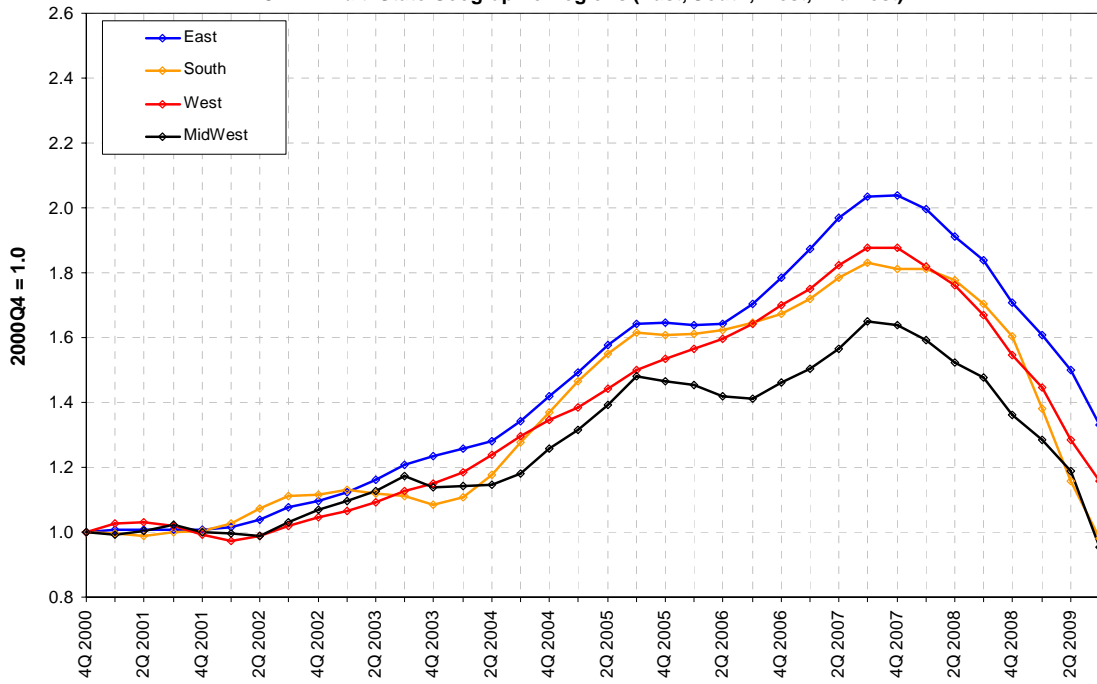
	Mean/Yr	Rise	Fall
SupCon CBD	4.7%	144.6%	-38.9%
SupCon Non-CBD	2.8%	95.4%	-34.9%
NotCon CBD	-0.6%	88.9%	-49.9%
NotCon Non-DBD	-0.4%	72.4%	-44.0%
	Mean/Yr	Rise	Fall
East	3.3%	103.9%	-34.8%
South	-0.2%	82.9%	-46.4%
West	1.7%	87.7%	-38.3%
MidWest	-0.5%	64.9%	-42.1%

There appears to be interesting divergence in price-change performance across locations in both exhibits, but the divergence is greater in Exhibit 5. In the contiguous regional definitions of Exhibit 4, the NCREIF East Region outperformed the other regions in both the up market and the down market of the 2000s decade. The Midwest and South

\* When the synergy between geographical location and regional economic change causes an evolution in the highest-and-best-use (HBU) from one property type to another, that is part of what can cause real estate investment to either succeed or fail in the long run. Why dilute this effect by segregating price indices by property sector? (Note, however, that the indices shown in Exhibits 4 & 5 are not complete "location value" indices because they are based on the CPPI data which filters out properties whose usage or size has changed between the first and second sales. But by aggregating across type sectors we do allow for cross-sectional differences in HBU.)

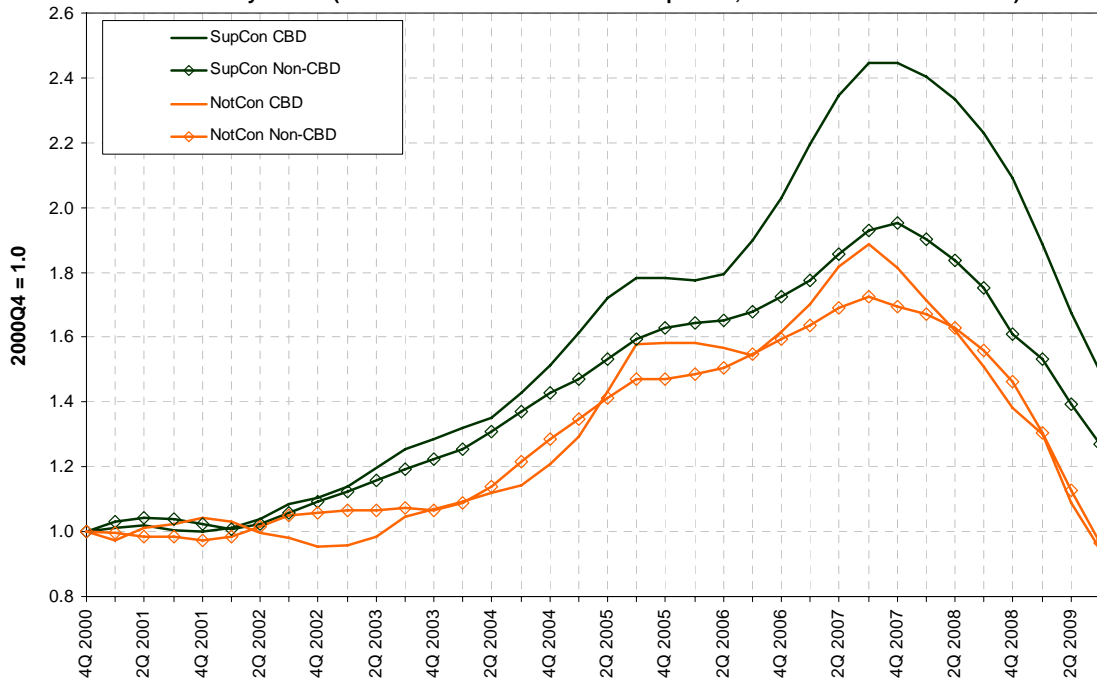
† CBD boundaries are as defined in the RCA database based on zip code. SupCon and NotCon are defined as described in my last month's commentary, with SupCon defined as locations where new development is relatively difficult or expensive (although at a fairly gross level grouped largely by state).

**Exhibit 4: Commercial Real Estate Same-Property Price Evolution (CPPI-based), 2001-2009Q3:  
NCREIF Multi-State Geographic Regions (East, South, West, MidWest)**



Note: All core property sectors aggregated. Source: Authors' estimates based on RCA repeat-sales transaction price data.

**Exhibit 5: Commercial Real Estate Same-Property Price Evolution (CPPI-based), 2001-2009Q3:  
Land Value Dynamics (Constrained vs Unconstrained Dvlpt Mkts, CBD vs Non-CBD Locations)**



Note: All core property sectors aggregated. Source: Authors' estimates based on RCA repeat-sales transaction price data.

produced the lowest price performance, with the West in between. The range between the best and worst performance was 3.8%/year. Interestingly, the non-contiguous locational groupings in Exhibit 5 produced a broader range of price-change outcomes, as economic theory would suggest. The range in Exhibit 5 is 5.3%/year, with CBD properties in Supply-constrained markets far outstripping the other groups.\* In general, the Supply-constrained markets outperformed the Not-constrained markets, and within the latter there was little difference between CBD versus non-CBD locations. In contrast, CBD locations performed considerably better than non-CBD locations in Supply-constrained markets. Investors in CBD properties in Supply-constrained markets realized 49% higher same-property prices in 2009Q3 than at the end of 2000, while investors in such properties in Not-constrained markets ended up with prices 5% lower than 2000.

The geographical all-property (“location value”) indices depicted in Exhibits 4 and 5 are intellectually interesting, and offer food for thought regarding real estate investment strategy. It is important to recognize, however, that they are only price-change indices, not indices of total investment returns. Perhaps more importantly, they only cover one decade of history (though one with a particularly dramatic pricing cycle).

-David Geltner, January 2010.

(See [www.realindices.com](http://www.realindices.com) for an archive of past issues of “Professor’s Corner”.)

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\* It should be noted that New York City is a large component of this index, including both office buildings and apartments in both Manhattan and the outer boroughs.