

“Professor’s Comments”

(For the December 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.

Ending a Wild 2009 on a Strong Positive Note!

The December result of the CPPI was very gratifying. It brought the fourth quarter of 2009 to a positive 3.6%, only the second positive calendar quarter since mid-2007. December was not only the second positive month in a row (first time for that since the summer of 2007), but December’s monthly gain of 4.1% was the best month in the history of the index going all the way back to 2000, lying 1.9 standard deviations above the mean of the 108 monthly returns since the index began (breaking the old record of 3.9% which occurred in January 2005 in the midst of the boom years). December capped the end of an incredibly wild year, one that may long survive in the record books of U.S. commercial property price movements, a year that saw six of its 12 months posting record or extreme (“beyond the tail”) results, five of those six on the negative side, but ending with the dramatic positive of December.

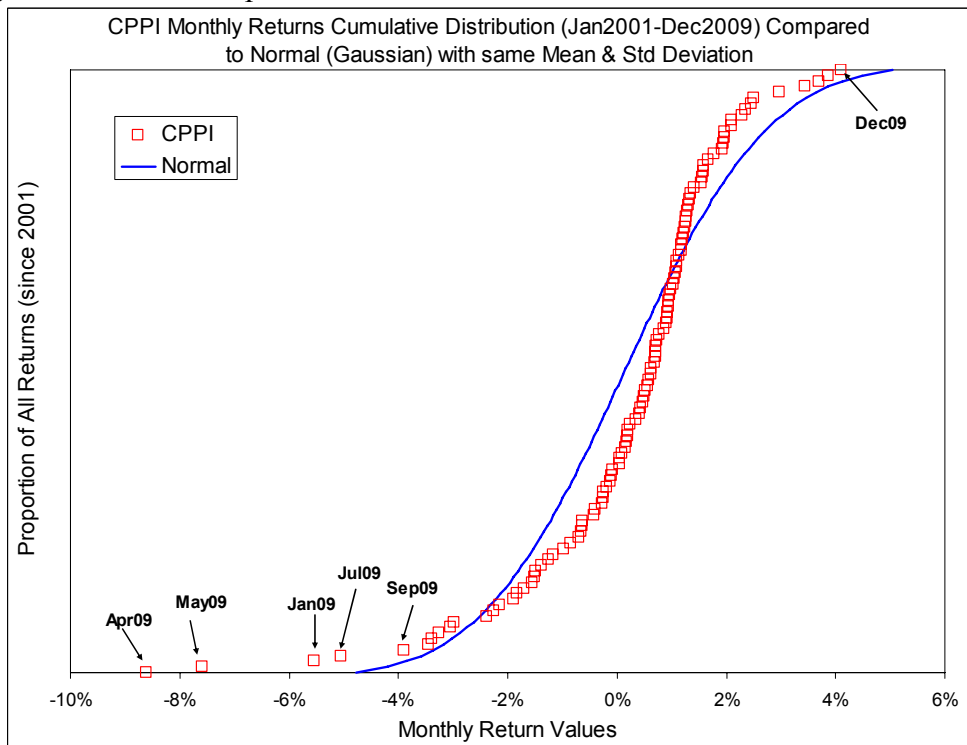


Exhibit 1

The December price result does not come in isolation, but with a variety of supporting and confirming evidence suggesting that commercial property in the U.S. has found a solid bottom, at least for now. Some of this evidence is almost “old news” by now, including the upturn in the GDP which began in the third quarter and the surprisingly strong rebound in the stock market and especially the REIT market that took off in the second quarter of the year. Housing prices also turned around and bounced up a modest 5% or so during the summer (by the Case-Shiller Index) before running into some uncertainty last fall. Of more direct relevance to the commercial market, trading volume as tracked by Real Capital Analytics (RCA) for major assets similar to those underlying the CPPI increased strongly in December, making December the strongest trading month since late 2008, with some three times the volume of the nadir month of April. Thus, commercial property prices were one of the last major indicators to hit bottom in the Great Crash of 2008-09.

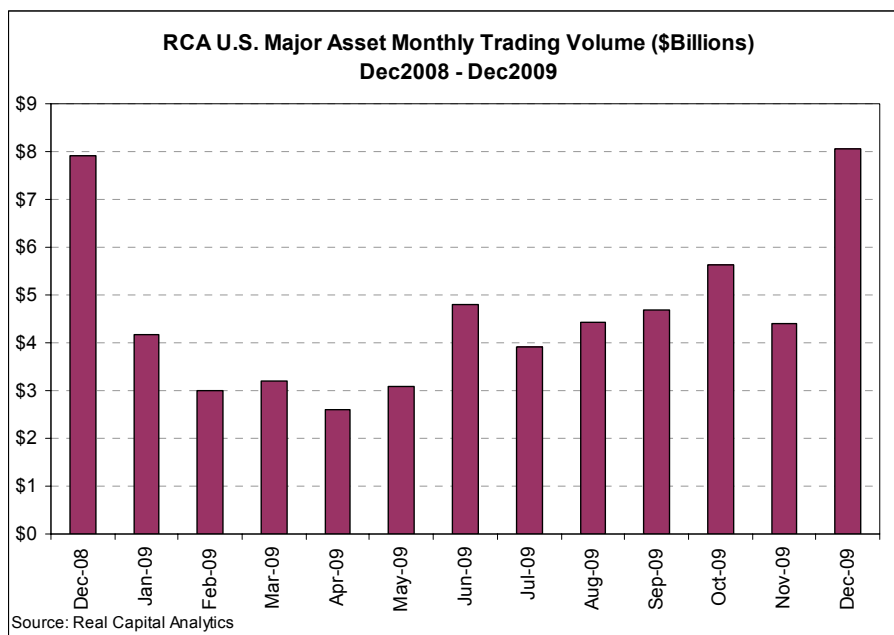


Exhibit 2

But it does seem that commercial property transaction prices have found a bottom now, at least for the time being. The two major dangers that could conceivably still push prices down again would be a reprise of the recession in the form of a “double dip” in the real GDP, or a swamping of the property market with a wave of distressed “fire sales” that could push the market into a “negative bubble”. For now, both of these possibilities seem to be fairly remote, with perhaps the second danger being still of some concern.

In particular, it is not totally clear how the market will handle and digest nearly \$1 trillion of commercial mortgages coming due in 2010 and 2011, including \$40 billion of 2006-08 vintage CMBS loans originated during the peak. However, lenders, special servicers, and the Government seem to be very determined to avoid excessive distressed selling. Most of the near-term maturing debt is in the hands of banks which have more flexibility and more Government support than the CMBS REMIC trusts for facilitating workouts and

restructurings of loans. And there remain vast quantities of vulture capital on the sidelines getting more and more ready to pounce.*

The result seems to be a balance of sorts, at least for now, and this is what undergirds the pricing bottom that the market has found. There is some distressed selling, but it is not overwhelming the market. Significantly, both the distressed and “healthy” property prices in our informal break-out of the repeat-sales in the CPPI rose strongly in December, each up over 4%. Thus, while the proportion of RCA “troubled assets” in the CPPI repeat-sale sample increased in December to 25% (from 15% in November), this did not prevent the overall index from rising. Apparently the 25% troubled assets is a digestible rate of distressed selling for the market, at least for now. The fact that even the distressed sales showed an increase in pricing bodes very well for the market, suggesting that the vultures may be beginning to pounce rather vigorously on a so-far-disciplined supply of carrion.†

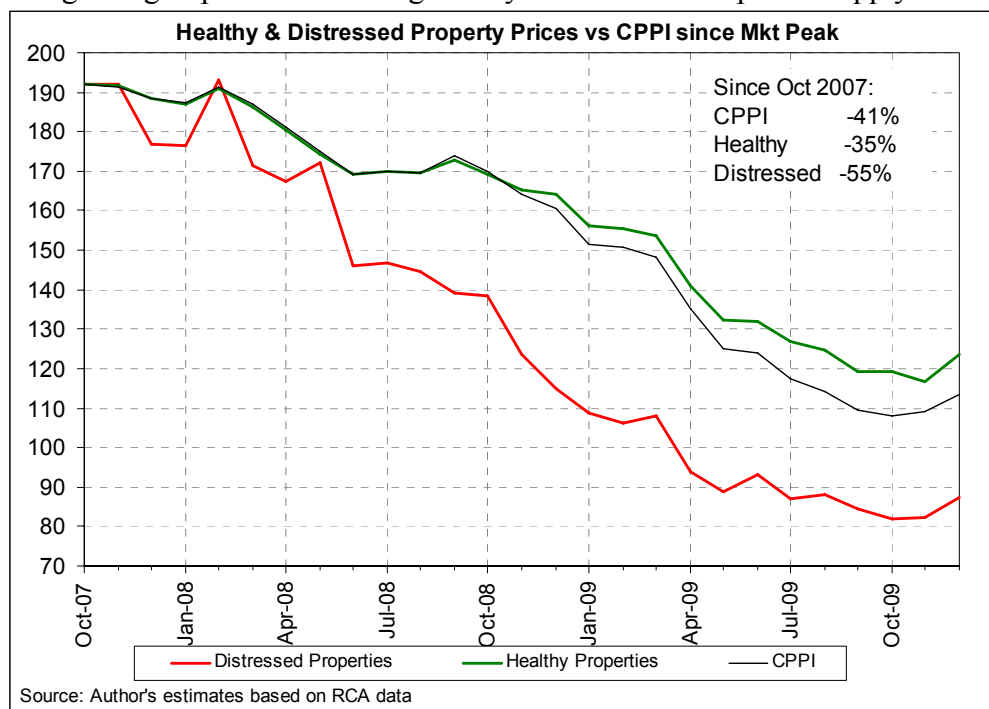


Exhibit 3

With the above encouraging words in mind, I nevertheless don't want to leave the reader with the impression that the U.S. commercial property is out of the woods yet, or that we are on the threshold of a significant rebound or sustained upward trend in prices. While trading volume is up from the bottom of last spring, it is still very low by recent standards. Of course I do not have a crystal ball, and I suppose anything is possible, but there are huge forces, both fundamental and technical, acting to prevent property prices from rising much above their bottom of late 2009. One is the continuing weakness in the

* Estimates I've seen range from over \$100 billion to over \$300 billion already raised or committed, from and in both public and private sources, domestically and overseas, targeted at U.S. commercial real estate. This capital is surely earning historically low returns while it is waiting.

† We must caution, however, that the distressed property price index break-out is based on a small sample, and the results in any one month should not be relied upon too heavily.

economy, especially in the employment dimension that directly underlies much of the demand for commercial property space (and hence rental markets). This will act to keep rental revenue down perhaps for several years or more. Another is the previously-noted overhang of property debt, perhaps half of it currently underwater, which will be coming due in a climate of much stricter and more conservative underwriting (and this even if/when the CMBS industry revives). I probably don't need to remind my readers that \$80 billion of 2006-08 vintage CMBS will be maturing in 2011-12, followed by another much bigger wave of over \$250 billion in 2016-17.* Furthermore, while current transaction price levels seem to provide a solid expected return for investors, there is little reason to believe they represent any particular "bargain" in the sense of providing a *higher* risk premium than necessary (i.e., if we have avoided a negative bubble, thankfully, that nevertheless means that there is no major bounce justified from the current prices).†

Pausing for a Look Back at the Downturn...

Supposing that the apt metaphor is that we were "falling like a stone" and now are "bouncing along the ground", we can pause now to look back at that two-year fall.

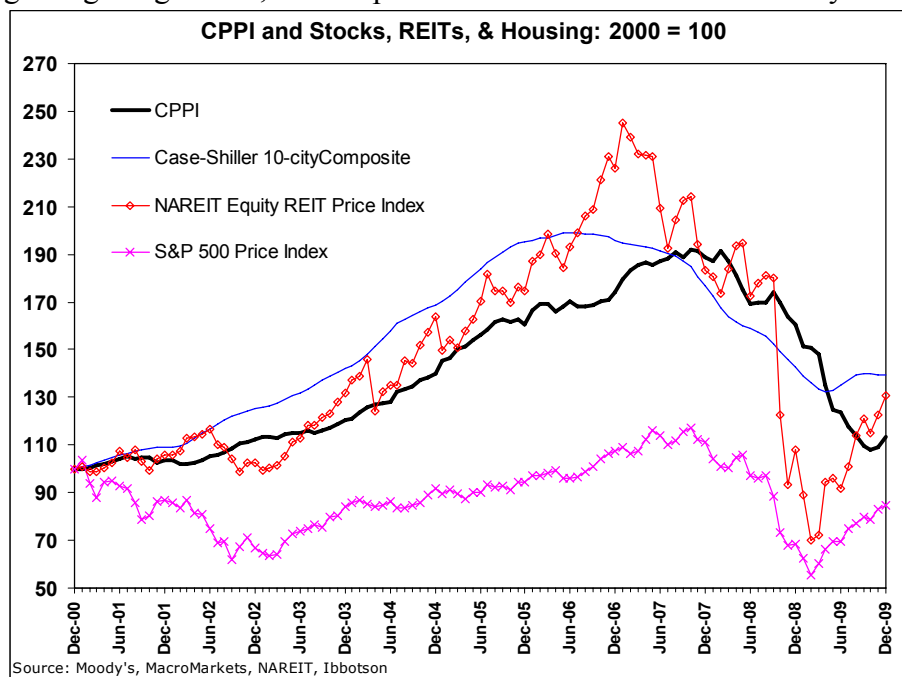


Exhibit 4

* See Gail Lee, "US CRE Debt Markets, What's Next?", *PREA Quarterly*, Fall 2009.

† Perhaps the strongest current counter-evidence to this "no bounce" assessment is in the level of REIT prices, which seems to suggest that the stock market, for one, believes the property market is a bargain. (Witness the difference between REIT yields and property cap rates.) While the stock market isn't always proved to be right *ex post*, it is a major source of information aggregation and of capital flow into the private market, and a leading indicator, so it is not to be ignored. If this perspective is correct, it suggests that, even if near-term challenges may keep property prices from much of a bounce for the time being, going out 3-5 years there could be a substantial upswing (or perhaps sooner in anticipation of that?).

From the CPPI peak of 192 in October 2007 the index fell in nominal terms almost 44% to 108 in October 2009.* In real (inflation-adjusted) terms, the peak was August 2007 and the drop was over 45%. Exhibit 4 puts this drop in some perspective. It came after a CPPI price rise from December 2002 of 71% (48% real), and the CPPI fall was part of a much broader crash across all the major asset classes, including (among others) drops of:

- 71% in the NAREIT Equity REIT price index (from January 2007 to February 2009);
- 34% in the Case-Shiller Housing Index (from June 2006 to April 2009); and
- 53% in the S&P500 Price Index of large-cap stocks (from October 2007 to February 2009).

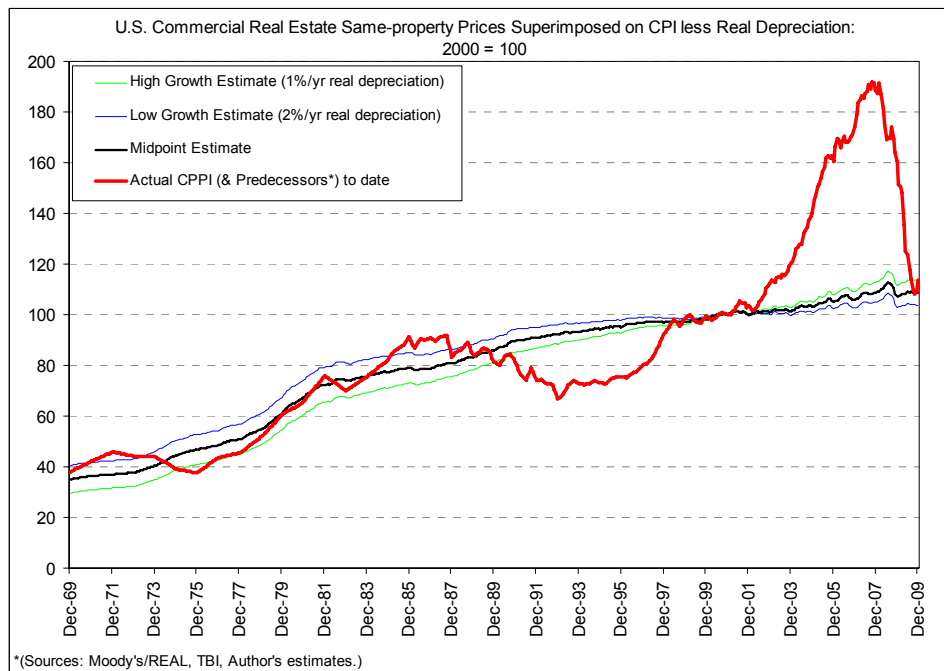


Exhibit 5

Taking an even longer perspective, employing the “extended CPPI” that I have introduced in previous commentaries, we see in Exhibit 5 that the 2007-09 fall was the

* I should note that if one measures the drop in the CPPI at the quarterly frequency then the peak-to-trough drop (from 3Q07 to 3Q09) was 42% in the All-property Index. But if we examine the four national sector indices (apartments, industrial, office, retail), then the peak-to-trough drop ranged between -40% for apartments to only -29% for retail (industrial and office were -37% and -36% respectively). This “out-of-bounds” phenomenon in which the All-property Index dropped farther than any of the national sectors is due almost entirely to the six non-end-of-quarter months during the last three quarters of 2009. We are still analyzing this difference, but its nature and magnitude suggests that it is not due to statistical noise in the indices, but rather to some systematic phenomenon active in 2009 in which sales data arriving later at RCA included in the quarterly indices but not in the monthly index exhibited relatively higher pricing. Preliminary evidence suggests that smaller properties may have been under-weighted in the monthly index during the non-end-of-quarter months (and relative to the quarterly indices), and during the severe downturn these smaller properties may have pulled up the quarterly indices relative to the monthly index. (See my December commentary for some CPPI-based evidence that smaller properties tended to perform better than larger properties in the recent downturn.)

latest in three major “crashes” in the commercial property market in the past 40 or more years (possibly the only such major declines since the Great Depression). Measured in real terms the two previous price drops were 43% from 1986 to 1992, and 39% from 1971 to 1975. The current price drop was much swifter, from a sharper price peak. The recent drop was considerably greater than the two previous ones in nominal terms, which is what causes the biggest problem with mortgage defaults, because the previous drops occurred in times of higher inflation, which helped to mitigate the nominal price decline. In retrospect it was possible to see that the two previous big declines went into “negative bubbles”, in the sense that commercial property subsequently provided multi-year sustained price growth substantially in excess of what was required to provide real estate’s long-run average investment return risk premium, even before and without counting any price climb into a subsequent bubble. As noted, so far I believe we have avoided a major slide into a negative bubble this time around (although there may be those who disagree with me on this point, particularly given the magnitude of the REIT price recovery).

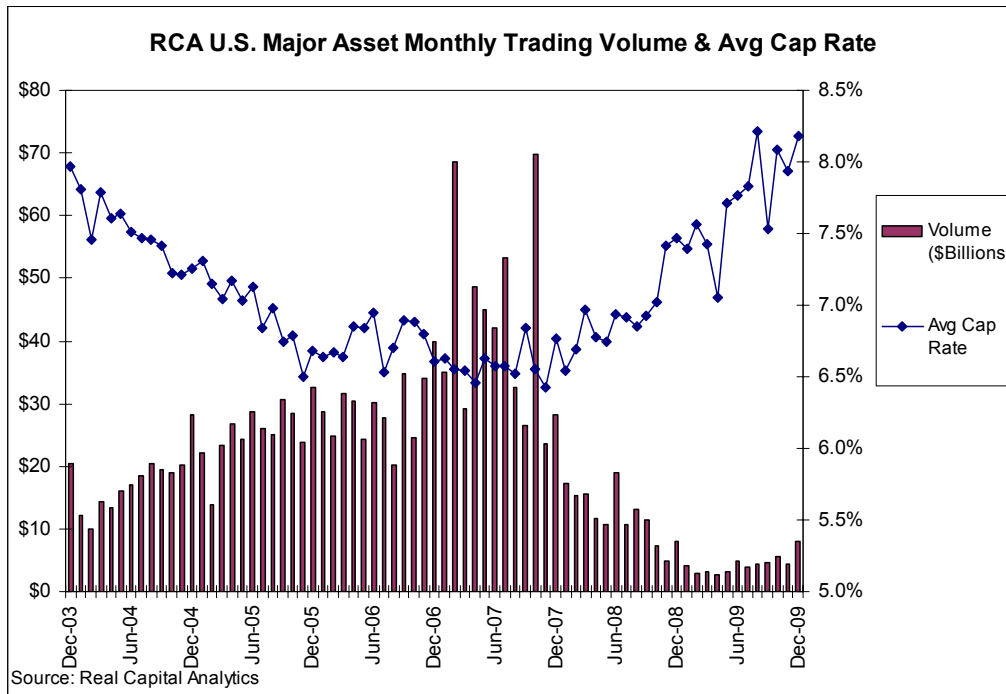


Exhibit 6

Exhibit 6 traces the rise and fall in RCA trading volume and cap rates over the past five years. Peak 2007 average monthly trading volumes in excess of \$40 billion were decimated to less than \$4 billion by the spring of 2009, a fall in liquidity that was certainly deeper than either of the previous two major downturns. After dramatic cap rate compression during the preceding decade, cap rates rose from the mid-6% range to over 8% where they are now, even as the projected NOIs on which the cap rates are based were taking haircuts on the order of as much 20% or more.

Finally, it seems appropriate that I end this review of 2009 with a brief look-back at what I said a year ago in my February 2009 commentary. At that time I noted that 2008 had

posted a record annual price decline of 15%, but that it seemed “certain” that 2009 would bring further major declines. I also suggested that the early phase of the downturn, which included the latter part of 2007 and most of 2008, had witnessed a sluggishness in commercial property price declines due to “loss aversion” behavior on the part of sellers. But I predicted that the economic collapse in 2008 would cause distress among property owners that would force them to begin selling at more substantial losses during 2009, and I predicted a further price decline of 15% for 2009. It now seems that much of what I (and many others) foresaw a year ago did indeed transpire during 2009, but with price declines far greater than I expected (29% instead of 15%), and drop offs in trading volume last spring that were truly breathtaking (for a data hound), but finally ending the year with a more encouraging upturn than I had dared to hope for at this time last year. *A wild ride indeed...**

-David Geltner, February 2010.

(See www.realindices.com for an archive of past issues of “Professor’s Corner”.)

* And do you, oh best-beloved readers, want Professor Geltner’s prediction for 2010?... Well, for what it’s worth... Anyway I can’t escape because I am already on record (writing last December) predicting that 2010 will see the CPPI All-property Index end somewhere between 0% and 15% above its late-2009 bottom, with my most likely guess being +10%. (See my article in the Winter 2010 issue of the *PREA Quarterly*, where you will see that a big reason for the optimism in that prediction is what has happened in the REIT market.) The December result therefore makes me a little nervous because it means we are already halfway to my prediction point. But I anticipate some bouncing around in the index in 2010, negative as well as positive.