“Professor’s Comments”

(For the April 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.

Another negative record…
The April 2009 Moody’s/REAL All-property index registered a drop of 8.6% compared to March. This smashes the previous record for the worst single month, set in January of this year at -5.5%. A drop of this magnitude in a single month is truly astounding for a private real estate market. Coming on the heals of six consecutive previous months of negative returns, this exemplifies a market in a “tailspin”. According to the Moody’s Index the average U.S. commercial property price as recorded in completed transactions has fallen over 22% in seven months, more than 25% in one year, and 29.5% since the market peak a year and a half ago in October 2007. Considering that private real estate return volatility is generally considered to be only about 10% per annum, to fall 22% in seven months represents a drastic and historic rate of decline. And the rate of decline actually seems to be accelerating.

If real estate returns were normally distributed with a standard deviation of 10% per annum, a common assumption, then a 22% drop in seven months would represent an event almost three standard deviations below the mean even if the mean return is only zero. Such an event would have a probability of less than 0.20%, implying that we have just experienced a seven-month stretch that would be expected to occur on average only once in over 300 years. Clearly, stocks and bonds are not the only asset classes subject to “fat tails”.

Some perspective…
While these numbers are indeed scary, they should be put in some context. First, keep in mind that deals closed in April generally represent prices agreed during March and even February. Those two months saw the recent nadir in market sentiment across all the global capital markets, as evidenced by the sharp rebound in stock markets since March (including notably in the REIT sector). While nothing guarantees that we won’t have a “W”-shaped recession and that market sentiment could head south again, for now there seems to be some hope that the bottom may have already happened at least in the equity markets. This does not mean that the private property markets have yet reached their bottom, but it might signal the first sign of a hint of a light at the end of the tunnel. (Let’s see, did I qualify that sentence enough?)

An important development in the evolution of the down-market did begin in April. While property trading volume in April was still at an historic low (below what I would have thought possible even as recently as last year: only about one-tenth the peak levels of two years ago), the transactions in April were for the first time beginning to include some

"distressed" property sales, according to Real Capital Analytics. This includes sales of properties being sold as REO by lenders after foreclosure. This is the type of selling that can drive prices down rapidly and bring the market quickly to a bottom.[*]

How low can we go?...

Nevertheless, even though prices are now at a level that as recently as last February I predicted could be the bottom, it is clear that the commercial property market still has a ways further down to go. One sobering way to look at the question of where we will ultimately end up is the following…

Suppose commercial property market values were at their long-run equilibrium level at the end of 2000 when the Moody's Index began (the starting value of "100" in the index level). While there is no way to know if December 2000 values were indeed such a holy grail of price levels, clearly 2000 was not at the bottom of a trough (such as the early-mid 1990s) nor at the top of a peak (such as the late 1980s or 2007). So perhaps 2000 prices were around a typical long-run average level. Now consider that properties tend to depreciate in real terms over time as they age. Physical and functional obsolescence takes its toll. While we do not know the exact rate of such depreciation, it probably lies in the neighborhood of 1% to 2% per year, even after routine capital expenditures are made. As a repeat-sales index, the Moody's tracks same-property prices, that is, prices that should reflect the real depreciation of the physical assets (exactly as investors are subject to). If we started at a value of 100 at the end of 2000, and depreciated in real terms at 1% per year, then by April 2009 we would be down to a value of 92, and if the depreciation rate was 2% then we would be down to 84.5. Now add the cumulative inflation since 2000 onto those values and you get an implied long-run equilibrium value level in the index as of April 2009 of between 104 and 113. Yet the All-Property Index was at 135 in April. If it did fall all the way to the 104 to 113 range, that would mean we still need to fall another 22 to 31 points on the index. That would represent a cumulative drop from peak of roughly 40% to 45%. And so far we're down only about 30%. But at the rate we're falling, we'll get to the bottom soon, perhaps even before the end of 2009.[†]

On the other hand…

Let me hasten to add that the above analysis might be too gloomy. Perhaps the December 2000 level of U.S. commercial property prices was below the long-run equilibrium level. The index subsequently rose almost 60% in real terms in less than seven years. And while we know the last part of that rise was a "bubble", it's not necessarily the case that the entire rise in the market after 2002 was unsustainable in the long term. Net of inflation the all-property CPPI in April is now back down to where it was 5 and ½ years ago in

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[*] Foreclosure transactions themselves are not included in the index as they do not represent arms-length market prices, but when the lender taking possession subsequently sells the property in a market transaction it is picked up in the index.

[†] This would be a much faster fall than has occurred in the housing market. If commercial prices indeed bottom out by the end of this year, then the entire fall will have taken only two years. Housing prices peaked in June 2006 (according to the Case-Shiller repeat-sales index), and they are still falling almost three years later and don't look like they'll hit bottom before the end of this year, which would be a decline of more than three years.

October 2003. Were prices unsustainably high in 2004? If you don't think so, then the Moody's indexes are telling you that we are already down to solid values.[*] Don't forget that U.S. commercial property markets were not seriously over-built heading into the current recession. And there is today plenty of capital waiting on the sidelines to enter the property market, either directly or via the secondary market for commercial property debt (including CMBS). In short, while the downdraft is awesome, there are suggestive glimmers that the bottom could be near, although not necessarily. Alas! The only thing that's for sure is that things are getting pretty suspenseful.

Completing the 1Q09 sectors…

Finally, let's not forget that the June report of the CPPI also includes the results for the year ending March 31, 2009, for the 16 market segments that are reported annually. These include all four sectors in both the East and South NCREIF Regions, as well as eight specific MSA-level market segments. These sub-indexes are all showing double-digit annual declines, with several segments dropping more than 20% in the year through March. Among these annual indexes the biggest losses were registered in South-Industrial (-29%), East-Office (-27%), South-Office (-25%), South-Retail (-23%), and Southern California Office (-22%). These numbers compare to a drop in the all-property index of 21% over the same period of time. The smallest losses in the 1Q09 annual indexes were in Southern California Industrial (-11%) and Metro New York Office (-13%). However, it should be noted that these latter two segments suffered an extreme reduction in transaction volume in the first quarter of 2009. In an annual index when the last part of the period covered has substantially fewer data points, this can cause the index to under-estimate the effect of low prices during the latter part of the year covered by the index report. Indeed, this phenomenon has affected most of the MSA-level indexes to some extent.[†]

-David Geltner, June 2009.

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[*] For the long run, apart from the PV effect of possible near-term recession-induced hits to property operating cash flow.

[†] The annual indexes (like the quarterly ones) use "time-weighted" dummy variables, which means that the indexes report price changes from the ***end*** of the preceding year to the ***end*** of the current year, not the change in the average prices throughout the years. Nevertheless, if data frequency falls off sufficiently in the latter part of the year being covered, and if that latter part witnessed the major part of the fall in prices, then it is possible that the annual indexes will not be able to fully reflect the fall in prices within the current year. If the price drop persists, then the index will pick it up in the next period.