

## “Professor’s Comments”

(For the June 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.*

### **A relatively good month:**

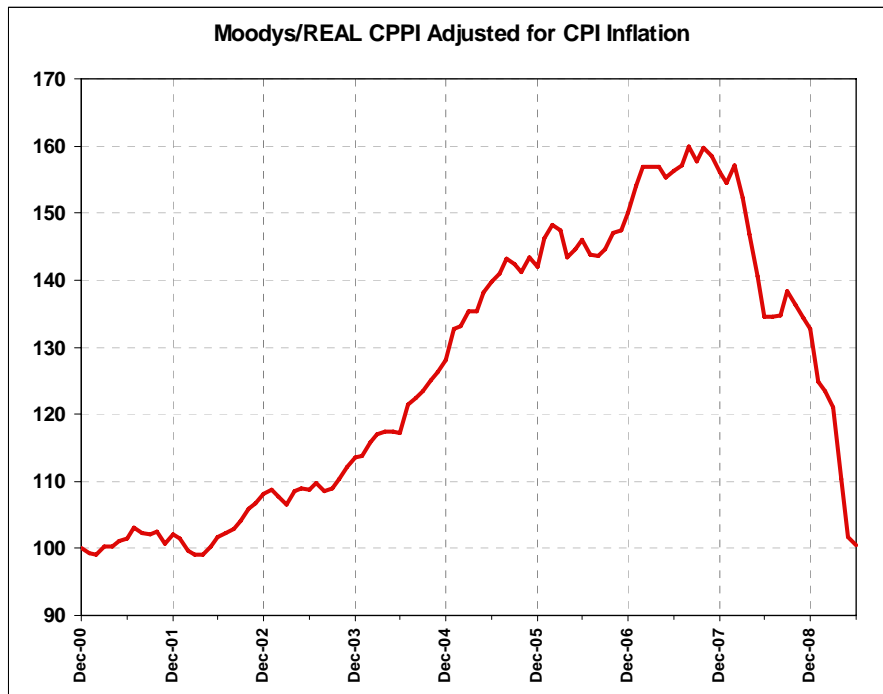
The CPPI was down again in June, the ninth straight monthly decline, to close out the second quarter with a record drop of 16.4%. But the decline this latest month itself was very modest, only about a point, to 124. After the collapse in April and May, this actually feels like good news. Of course it could be just a pause in the market drop. I would want to see at least a couple months in a row of actually positive returns before I would seriously consider calling a bottom or even a “ledge” on the cliff. So we are not there yet. But at least we can say this month is not unexpectedly bad news like the two previous months. It could signal the beginning of a gradual tapering of the decline, the beginning of the final stage of the price correction from the lofty bubble of two years ago.

The CPPI total drop from the peak is now 35.5% in nominal terms from October 2007, and 37.2% after adjusting for inflation from the peak in real terms which occurred in August 2007. The index level of 124 is now back to where it was in February 2004 (down from the peak value of 192), but in real terms the index is back to where it was in 2001 and 2002. (See the chart on the next page.) As I’ve noted in previous commentaries, a same-property price index like the CPPI would be expected to depreciate slightly in real terms over the long run on average, as properties age and their values must reflect functional and economic obsolescence.\* This might suggest that the index should fall farther if its starting value in 2001 was near the long-run sustainable equilibrium level for the U.S. commercial property market. The index may need to still shed another 10 to 20 points (to get to around 105 to 115) to get to the range implied in nominal terms (current dollars) by that assumption. If the market falls through such a bottom, into “negative bubble” territory, then the CPPI could go below 100. A value in the low 90s would probably correspond today in the CPPI to something like the equivalent of the prices of the early to mid 1990s when the market was clearly in a severe negative bubble. Of course, nowhere is it written in stone that the market must repeat itself or that it cannot move to a permanently higher sustainable plane (perhaps reflecting permanently lower

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\* The repeat-sales on which the CPPI is based do not have capital expenditures subtracted from the second sale value, and so the price index reflects the effect of capital improvements between the first and second sales. However, various filters are employed to attempt to weed out most major renovations or rehabilitation projects, for example by eliminating “flips” (of less than 18 months between the buy and sell dates) and observations whose size or use or construction dates have changed between the two sales. (An “extreme returns” filter is also employed, which eliminates any sale pairs with more than a 50% per annum price increase between the two sales.) My personal opinion is that the index does a good job of reflecting essentially only routine capital improvements of the type that are typically self-financed by the cash flow from the property itself and designed essentially only to maintain the physical quality of the structure and serve its current tenants.

real interest rates or permanently greater global liquidity). Thus, it is not necessarily the case that the CPPI must fall much (or even any) farther than it already has!

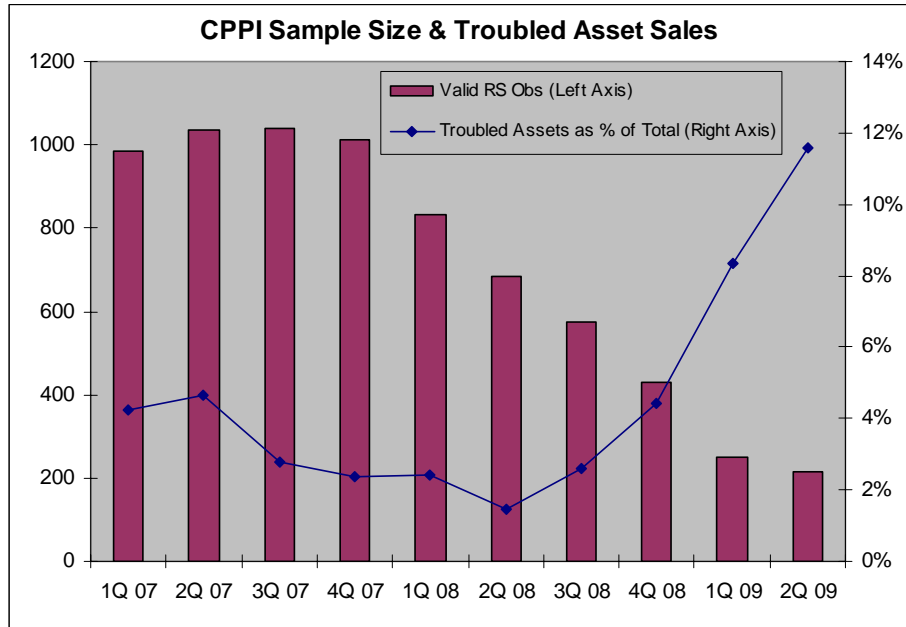


### **The numbers behind the numbers: volume and distress:**

To help us get a little more feeling about where we might be headed, let's drill down a bit behind this month's headline CPPI number. An important piece of good news is that volume ticked up smartly in June. RCA acquisition volume was up to over \$3.5 billion in June from \$2.5 billion in May. While still extremely low (barely 1/20<sup>th</sup> the volume of the peak month of February 2007), June's volume was the highest since January, and exceeded the previous quarter-closing month (March) by 30%. (The volume in transaction closings tends to have some quarterly seasonality.) The fact that volume increased without a large decrease in the price index suggests that potential buyers may have hit a floor in the reservation prices at which they are willing to deal, while property owners are continuing to come down sharply in their reservation prices at which they are willing to sell. This could be a sign of the beginning of the end of the fall in market transaction prices, as the demand side of the market (potential buyers) often leads the supply side in such turning points, and in such circumstances an increase in volume suggests the type of "capitulation" on the part of property owners (the supply side) which is necessary to restore the market to health.

Related to this point, another important indication is the role of distressed sales in the market. Until recently distressed selling had not really kicked in as a major factor in the commercial property market (unlike housing). But in June distressed sales jumped up to 18% of the repeat-sales database on which the CPPI is based (defined as the property at the time of the second sale in the repeat-sale observation being labeled by RCA as a "troubled asset" according to RCA's "Troubled Asset Radar" tracking system). This was

over twice the share of troubled assets in May, and well above the previous monthly high of 12% which occurred in March of this year.

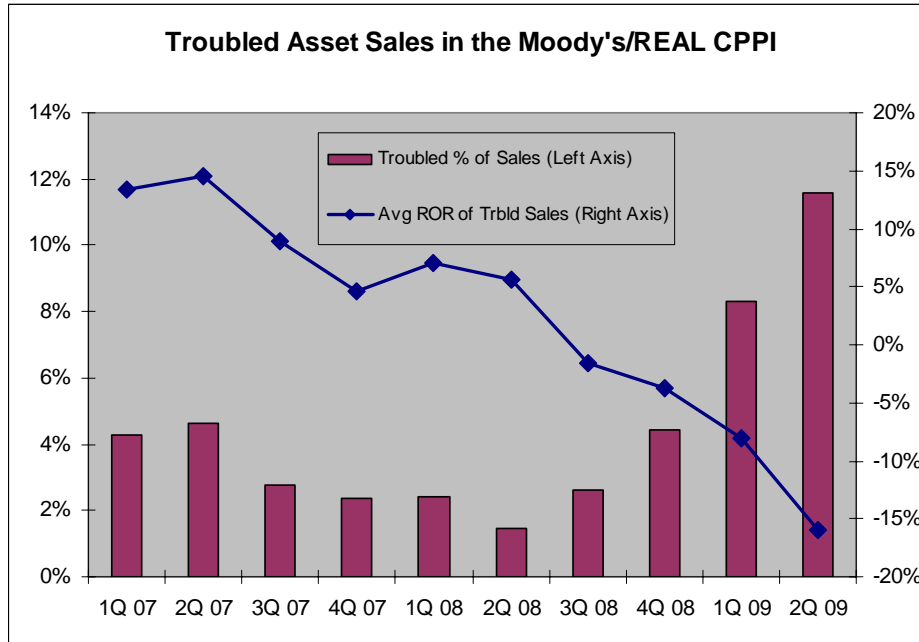


Distressed sales are definitely starting to have an impact on the market prices, moving the all-property CPPI down approximately two points lower in June than it otherwise would have been without any distressed sales.\* The chart above depicts the quarterly evolution since the peak in the CPPI sample sizes (which of course are highly correlated with RCA sales volume) and the proportion of the sample that was made up of troubled assets. It is interesting that in the early stages of the downturn the percentage of trouble-asset sales actually declined to below the average level. A weak or uncertain market is the worst time to try to sell a troubled property if one can avoid it. The substantial increase in distressed sales now after prices have fallen over 30% suggests that many property owners have reached the end of their rope.

It is a much different thing selling distressed assets at the bottom of the market, as the chart below suggests. The average troubled asset sale during the market peak in early 2007 was able to be accomplished at a strong positive rate of return of over 10%.† While this may have been slightly less than the average performance of healthy properties at that time, it had little to no impact on the CPPI. By 2Q09 the average distressed sale was occurring at a negative 15% ROR, well below the average of healthy properties, and bringing the index down as much as two points per month in recent months.

\* Of course we want to include distressed sales in the CPPI computation, as such sales are an important part of the real marketplace, and an important way that the market adjusts to the reality of supply and demand, reflecting the equilibrium valuation in the marketplace. The CPPI does not include foreclosure deeds, as these typically do not represent arms-length market transactions (often recorded at the loan balance). When a lender-owned property next transacts in the open market, it will trigger a valid repeat-sale compared to the last previous sale before the foreclosure, and such sale of REO is classified as a “troubled asset” in the RCA system. (There are other identifiers of “troubled assets” as well. See the RCA website for details.)

† This refers to the round-trip price change rate per annum between the first and second sales.



While distressed sales are painful to all involved (except, one presumes, to the buyers), they are a necessary ingredient in the market establishing a bottom. Distressed sales help to identify a realistic (and attractive) price level in the marketplace, and this in turn brings liquidity back to the market and sets the stage for future stability and perhaps even positive growth in prices. I expect there will be much more distressed selling of commercial properties in the coming months, and this will probably help to drive the CPPI down at least a bit lower than it currently is. But I do expect a bottom soon, I think by the end of this calendar year (presuming the global economy continues to improve), and I hope the bottom will occur at a level not much below where the index is now.

-David Geltner, August 2009.