“Professor’s Comments”

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

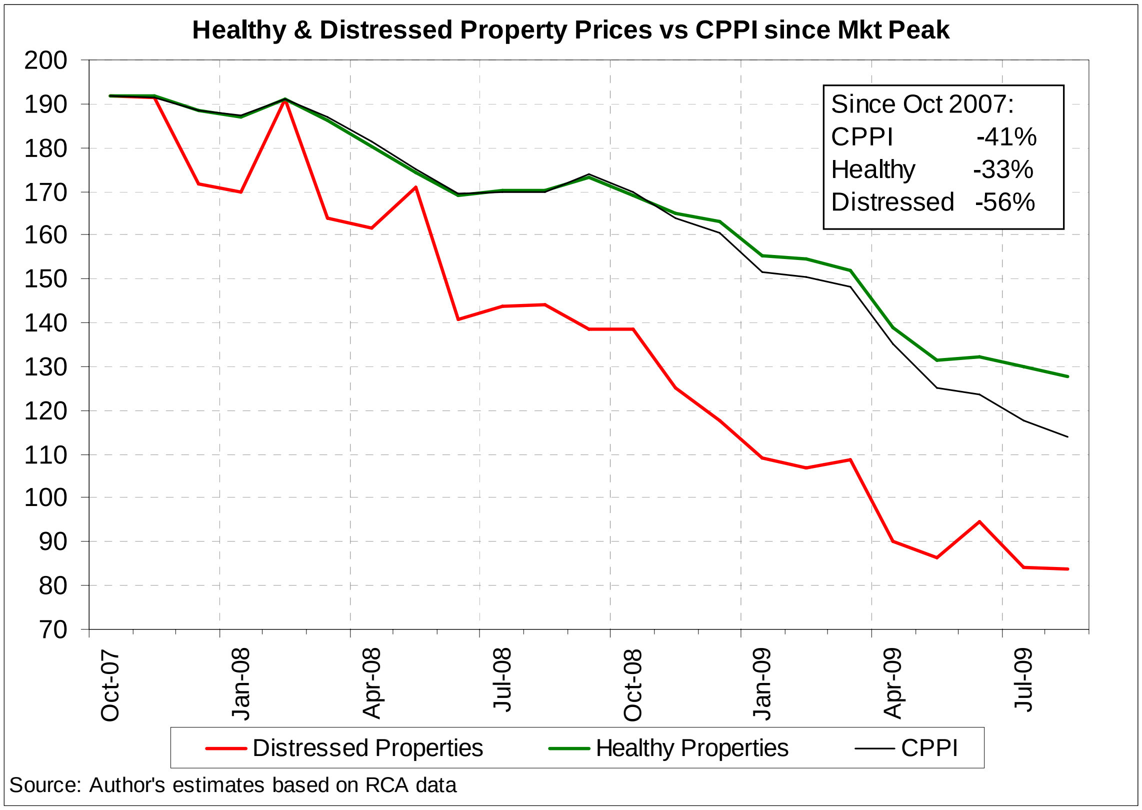
This is a periodic commentary which will generally be posted monthly on the “RealIndices” web site, offering the perspective on the indexes of Professor David Geltner (or occasional guest commentators). Geltner was a leader of the team at MIT that developed the methodology for the Moody’s/REAL Indexes.

Where we are in the aggregate: A two-year anniversary…
August 2009 marks the two-year anniversary of the CPPI’s “real peak”, that is, the price index peak adjusted for inflation (the nominal peak was two months later). To celebrate, the CPPI fell for the eleventh month in a row, dropping another 3.5 points, or 3%, to a value just above 114, down from 192 in October 2007. Through August the index is down 29% in 2009, 33% over the past 12 months, and close to 41% since that 192 value in October 2007. The current index level of 114 implies average market transaction prices in August 2009 at levels where they were in the spring of 2003. That spring was a time when the markets were worried about the “Iraq invasion”, when they were still struggling to recover from the tech bust and 2001 recession, when the Dow was in the 8000s, when the condo boom and most of the sub-prime housing lending and interest-only commercial mortgages were but a gleam in a few eyes, when CMBS AAA subordination requirements were still north of 17%, and well before the advent commercial mortgage CDOs: A time before the time before the current time; a time of innocence? And that is in nominal terms. Adjusting for inflation the CPPI is now down 42.6% from its August 2007 real peak to a level 8% below the index inception value of December 2000.

There were two small bits of good news in the August CPPI numbers. One is that the August price drop was less than the July drop, and considerably less than the collapse during last spring (when the index fell more than 15% in the two months of April and May alone). The “second derivative” in the transaction price changes is looking rather positive (the rate of decline seems clearly to be less in magnitude than it was). The second piece of good news is that commercial property transaction volume seems to be continuing to climb from its abyss of last spring. The climb is slow, and volume is still pitifully small by historical standards, but RCA reports well over $4 billion of closed transactions in August, the highest monthly total of this year (even though August is usually a relatively slow month). Perhaps more importantly, whether you view it as good news or bad news, the volume of distressed property sales transactions is continuing to increase, and beginning to make up a substantial proportion of the total sales. And this brings us to our analysis for this month of “the numbers behind the numbers”…

Healthy or distressed: Quantifying the market bifurcation…
The chart below presents an update and enhancement of a chart I introduced in my previous month’s commentary. Based on the same repeat-sales database as the CPPI, the chart uses RCA’s identification of “troubled assets” to produce separate indices of “healthy” and “distressed” property price movements since the October 2007 peak. The chart reveals that, through August 2009, while the overall CPPI has dropped 41%,

"distressed" properties (indicated by the RCA "troubled asset" designation) have dropped 56%, while "healthy" properties (those not flagged by the RCA "troubled asset" designation) have dropped "only" 33%.*



Starting from the 192 price value level in October 2007, by August 2009 the CPPI is down to the previously-noted 114 value level, while the healthy property index is down only to 128 and the distressed property index is down to 84. Assuming two similar properties of equal value in October 2007, one that has become "troubled" (by RCA's definition) and the other that has remained "not troubled" (meaning that it is not flagged by RCA's troubled asset designation), the indices suggest that the latter ("healthy") property would by August 2009 be likely to sell at some 52% higher price than the former ("distressed") property (based on the ratio 128/84). Suppose each of these two hypothetical properties had been financed by a mortgage which in October 2007 had a 75% LTV, then by August of this year assuming no amortization of the mortgage

* The "healthy" and "distressed" indices are produced using essentially the same methodology as the official Moody's/REAL CPPI. The "healthy" index is simply estimated without including the distressed properties in the database, while the "distressed" index is estimated on the complete data set but with additional time-dummy variables since the October 2007 peak interacted with the "troubled-asset" flag on the second-sale observation. The distressed property index is produced based on the sum of the estimated coefficients on the standard time-dummies plus those on the distressed time-dummies. Both the healthy and distressed indices are marked relative to the CPPI and set to a starting value in October 2007 equal to that of the CPPI at that time (the peak value of 192). Note that this method of defining and constructing the distressed index in the present circumstances makes it essentially an index of properties *falling into* distress since the market peak, as the observations flagged in the interacted distress time-dummies had their prior sales before the crash in non-distressed situations.

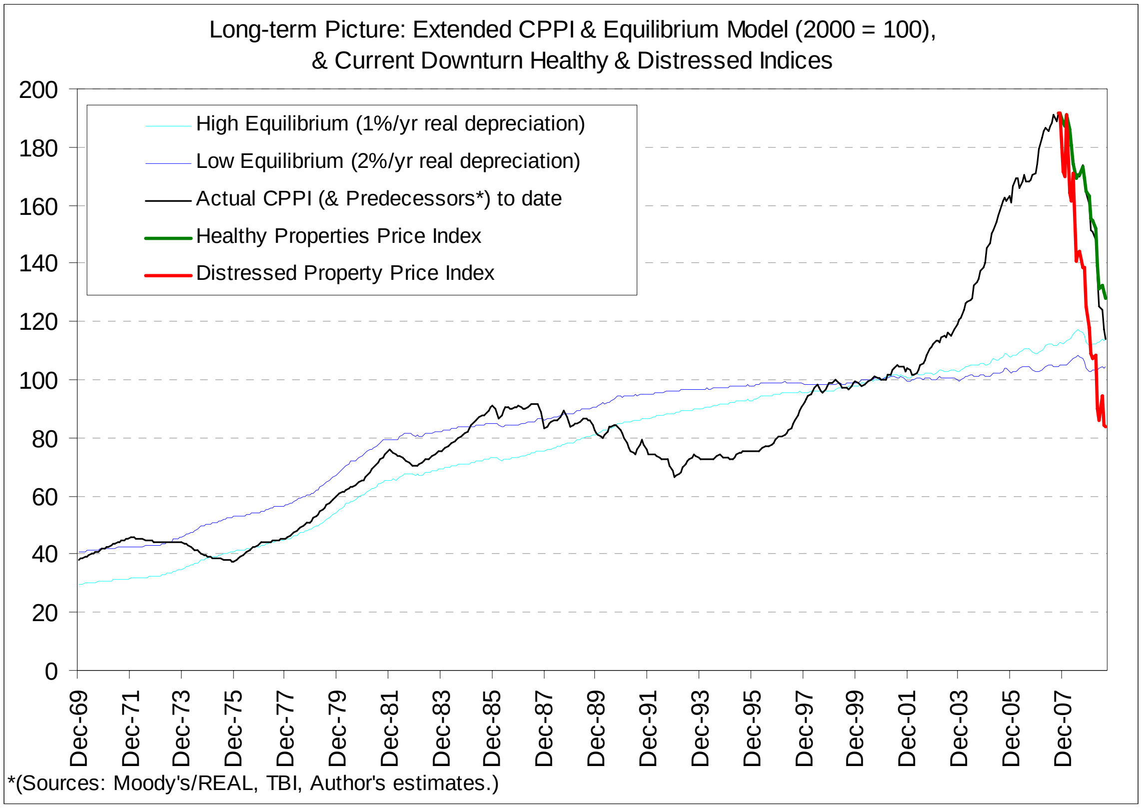
principal the healthy property's likely sale price would be 89% of the outstanding loan balance [128/(0.75X192)] while that of the distressed property would be 58% [84/(0.75X192)].

The chart of the "healthy" and "distressed" property price movements since the peak provides a compelling visualization of the bifurcation in the U.S. commercial property market that many industry participants have noted anecdotally. These indices provide a more rigorous and comprehensively based quantification of this price bifurcation than has been possible previously. In combination with other evidence, this allows a deeper analysis of the dynamics of the market since the downturn began.

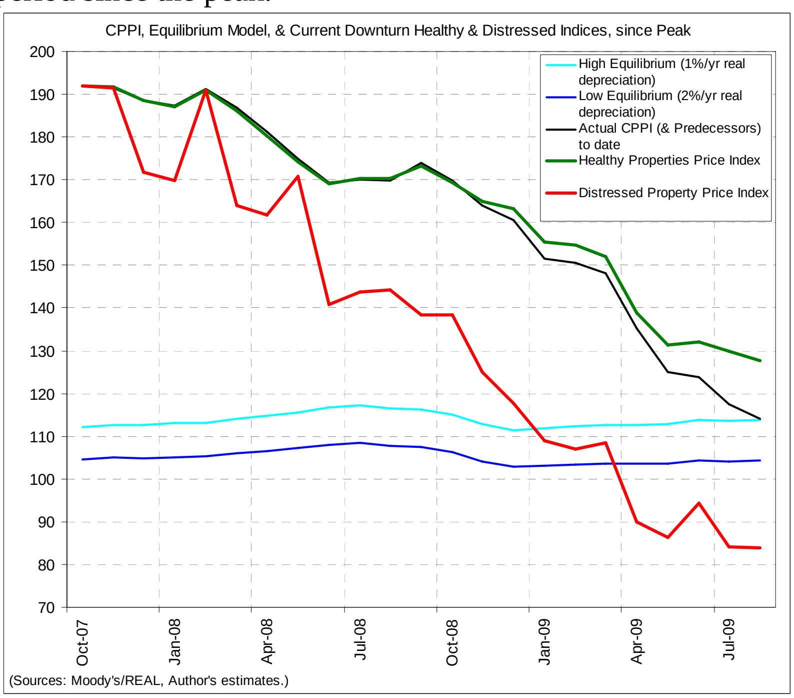
First, consider that, while the distressed property index in particular contains some noise at the monthly frequency, the side-by-side comparison over time of the healthy and distressed price indices allows a tracking of the history of the market bifurcation, which in turn provides a glimpse into the market's underlying structure and dynamics. The indices comparison suggests that the separation began in earnest in early 2008, widened in the fall of 2008, and again in the spring of 2009. There is a hint (only a hint) that perhaps (just perhaps) the distressed property prices in particular may be bottoming out. We must always caution that a single month does not a trend make, but in August the distressed price index was nearly flat. This suggests that the vultures perched on the sidelines of the U.S. commercial property market might consider swinging into action. And this may be beginning to happen, as virtually all of the previously-noted modest increase in transaction volume since the beginning of the summer has been in the growth of distressed property sales. Sales of "healthy" properties has remained nearly stagnant. Distressed property transactions made up a record 25% of the repeat-sales observations in the August CPPI.

Refining the idea of the "negative bubble"…
In my previous month's commentary I suggested that I was concerned that the U.S. commercial property market would fall into what might be dubbed a "negative bubble". By the term "negative bubble" I mean prices depressed "unnecessarily low", in the sense that they would present "super-normal" ex ante risk premia for buyers, greater expected returns than warranted by the amount of risk in the assets. This would of course be to the detriment of the sellers, who would likely include many banks whose balance sheets are needed to undergird any sustainable recovery in the U.S. economy. I showed a chart that presented an "extended CPPI" and a simple model of "long-run equilibrium" (or "sustainable") U.S. commercial property prices since 1970, which indicated that in the two previous major commercial property cyclical downturns (1970s and 1990s) prices had indeed dropped to such "negative bubble" levels. In the chart below I reprise that earlier graph (updated through August), with now the previously-described "healthy" and "distressed" property price indices since the October 2007 peak added at the end of the history.[*]

[*] Recall that the simple model of long-run sustainable U.S. commercial property pricing involves two assumptions: that the market was at such a level at the inception of the CPPI in 2000, and that same-property prices grow sustainably over the long run at rates 1% to 2% per year less than inflation (reflecting the real depreciation of the property structures).



Note that the distressed property price index has already punched through the lower-bound estimate of the long-run equilibrium price path and appears to be in what the chart suggests is "negative bubble" territory. This is more evident in the chart below which blows up the period since the peak.



At a current price level of 84, the distressed property index is some 23% below the current lower-bound estimate of the equilibrium property price level.[*] Of course, distressed properties are, well, “distressed” (or “troubled” in the RCA terminology). Arguably a substantial discount in the price of such properties is warranted by the particular circumstances of those properties, and does not necessarily indicate “negative bubble” pricing in the previously-noted sense of presenting a super-normal risk premium to the buyer (because such properties may carry “super-normal risk” compared to other properties). However, if the nature of the “distress” is more in the circumstances of the property seller than in the property itself, then there may be reason to question the need for such low pricing.[†] At a minimum, it would seem to be important for property appraisers to consider the differential pricing implied by the market bifurcation which the financial crisis and recession have opened up. Distressed property sales tend to receive a lot of press headlines, and certainly even healthy properties have taken a big hit since the froth of the peak, but the above analysis suggests that healthy properties may well be currently selling for premiums on the order of 50% above otherwise similar distressed property prices (though admittedly, not many of them).[‡]

In summary, the above analysis suggests that there may at least be a possibility that the dreaded (and dangerous, for the economy) “negative bubble” will not materialize for healthy properties (and healthy owners), but that perhaps it is already fully in place for distressed properties. It will be interesting to see how things play out in the coming months as distressed property sales undoubtedly will make up a larger fraction of the transactions. They could conceivably pull the overall CPPI down further, even without actually implying any further decline in the pricing of either distressed or healthy assets viewed separately. And this could have important implications for potential property investors who are still waiting on the sidelines. Why are you waiting?...

-David Geltner, October 2009.

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

[*] The lower-bound estimate of the “equilibrium” level by the simple model noted previously is currently a value of 104 in the CPPI. The upper-bound estimate is 114, now exactly equal to the CPPI.
[†] RCA’s “troubled” property indicator includes issues with the property owners, not just the property. For more information, see the link below:
http://www.rcanalytics.com/troubled-assets-methodology.pdf

[‡] Again, this assumes equal values at the peak.