



The Commercial Real Estate Bust: How Long? How Deep? And What Will Pull Us Out?

Western Independent Bankers: Troubled Asset Forum

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Hilton San Francisco

By:

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Today's Agenda

- | | |
|----------------------|---------|
| I. Why a CRE Bubble? | Past |
| II. Has it Popped? | Present |
| III. Forecast | Future |





Why a CRE Bubble?

- I. Equity redirected towards real estate from stocks
- II. Debt madness
- III. Economic expansion improved fundamentals

- I. Equity redirected towards real estate from stocks
 - '01 stock market crash
 - Change in institutional investors' asset allocation
 - More capital chasing real estate than available → cap rate compression → more capital chasing RE → cap rate compression
 - Global liquidity flood created by central banks, oil's rise (new wealth: Russia, Mid East, Brazil)

II. Debt madness

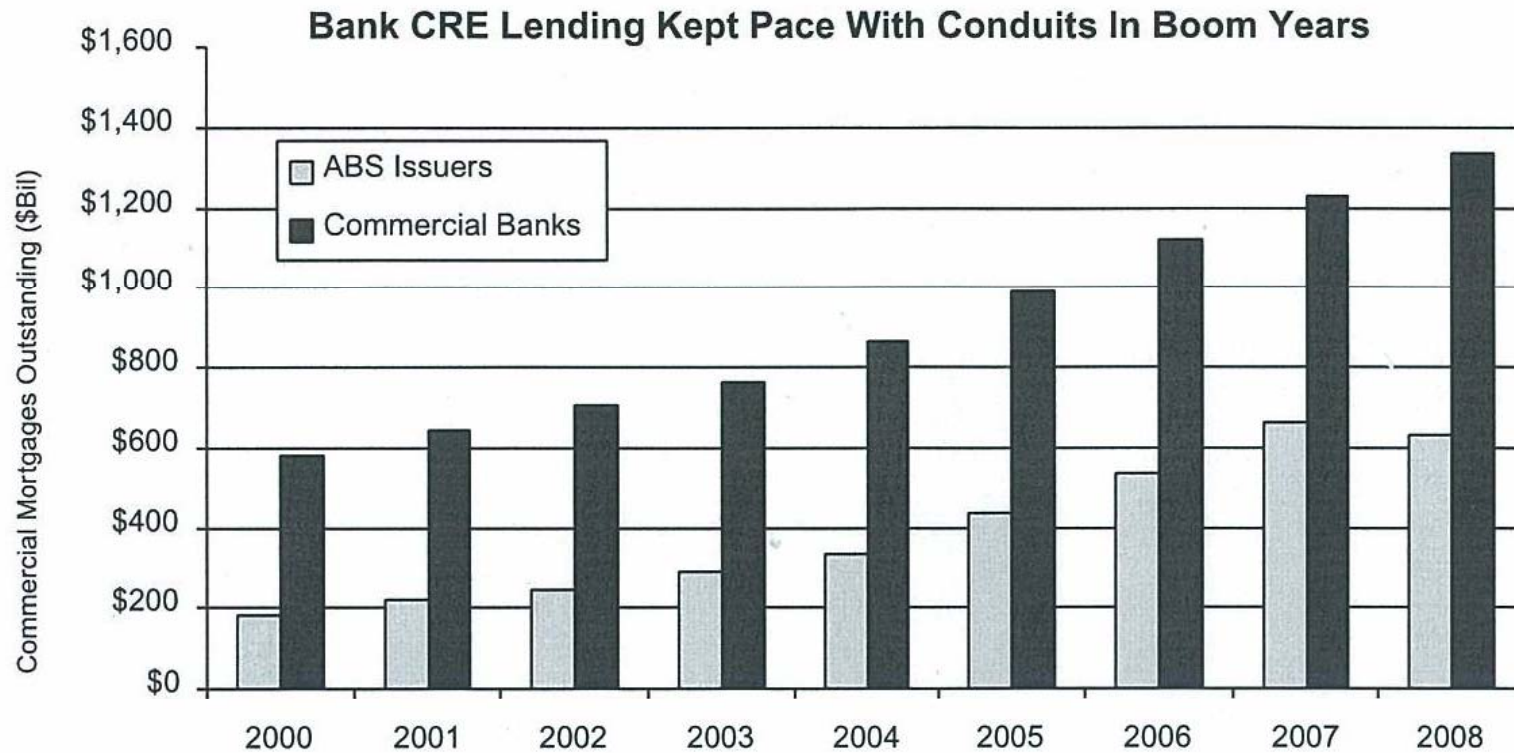
- CMBS pyramid scheme/scam
- Big banks become investment banks
- Community banks take highest risk/ highest margin loans

*Risk was completely mispriced due to greed (fees), competitiveness, shareholder pressure

Also chasing CRE debt...

- Big Banks
- Insurance Companies/Mortgage REIT's
- Community Banks

Why a CRE Bubble?



Source: FDIC Flow Of Funds



III. Economic expansion improved fundamentals

- Increasing Corporate Profits
- Increasing Employment
- Decreasing Vacancies

Why a CRE Bubble?

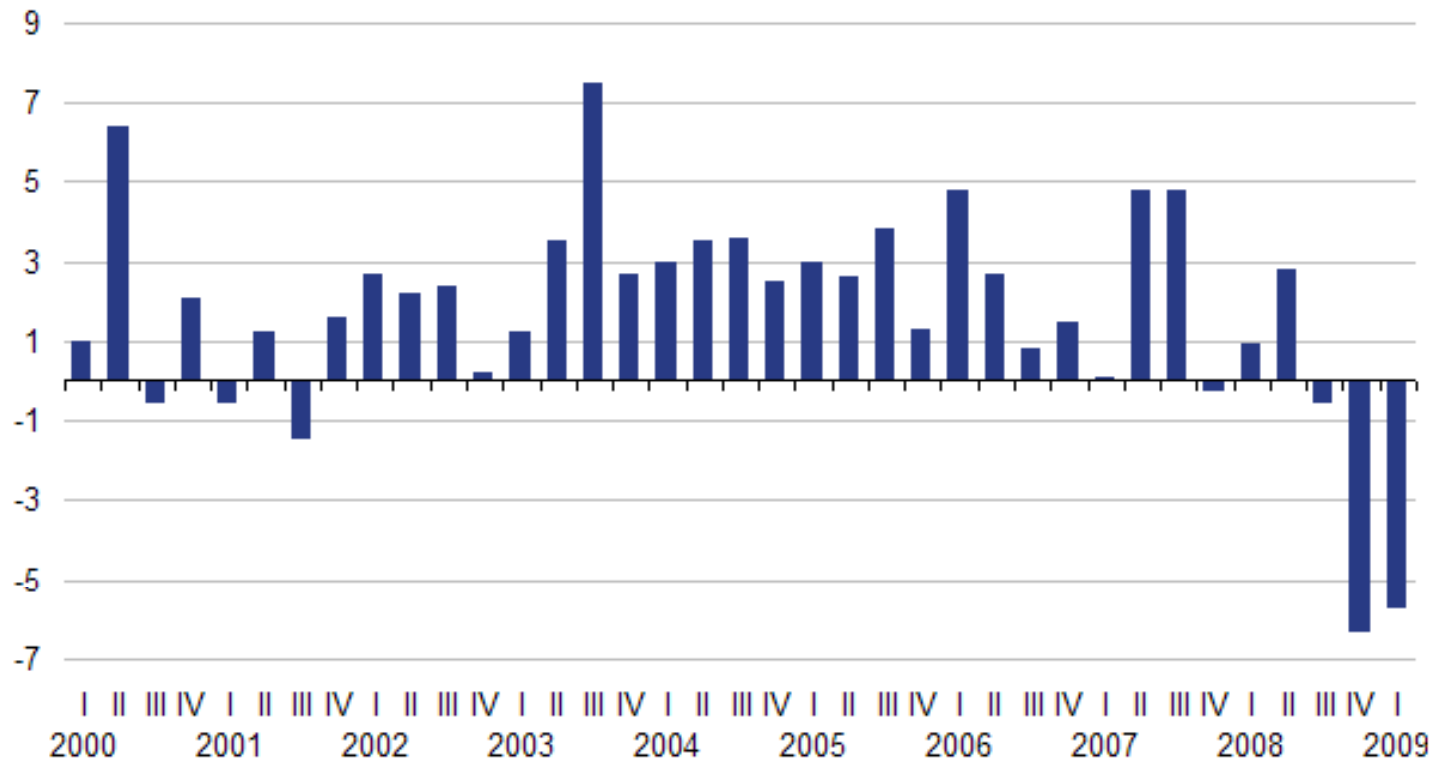
CRE was a credit driven bubble no different than housing



Why a CRE Bubble?

Real Gross Domestic Product

(Percent change, seasonally adjusted annual rate)

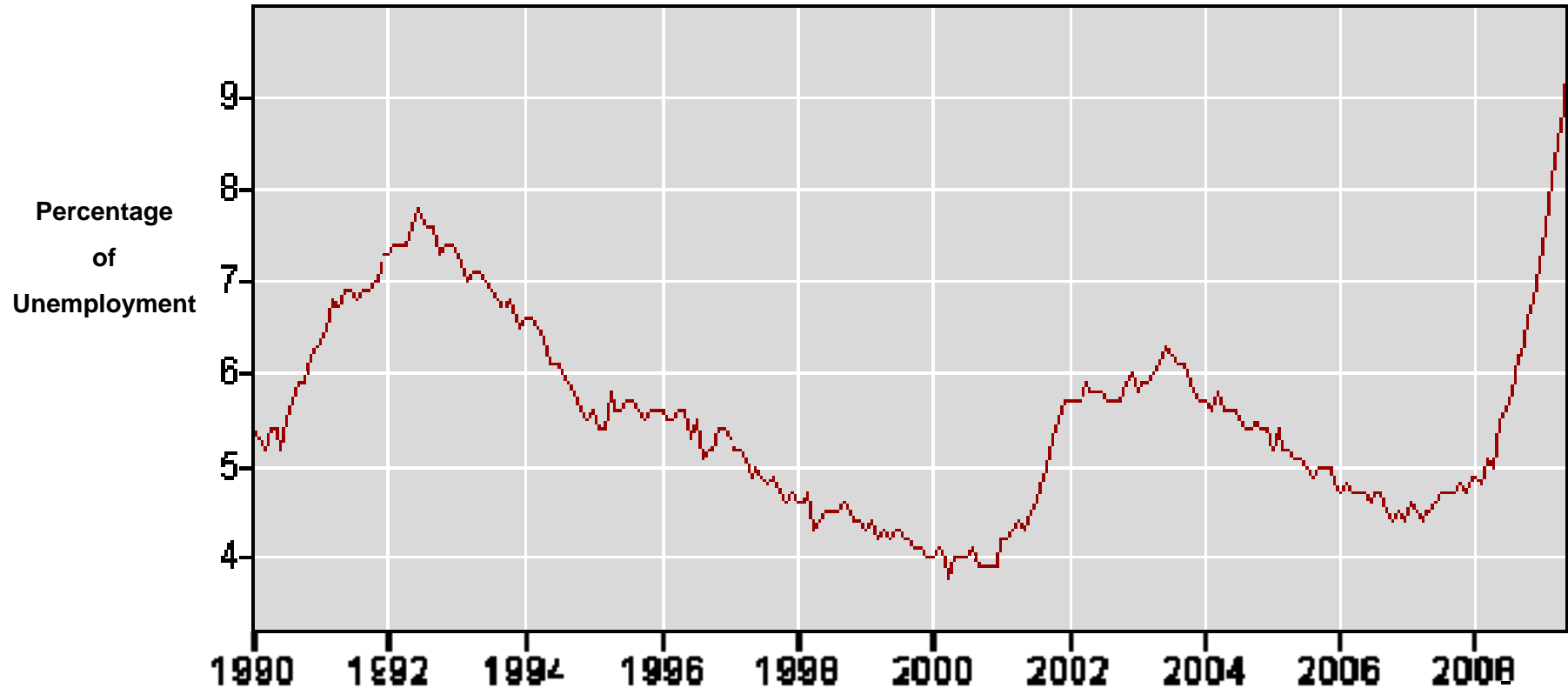


U.S. Bureau of Economic Analysis



Why a CRE Bubble?

U.S. Unemployment ('90 - '08)



Source: U.S. Dept. of Labor; Bureau of Labor Statistics, 2009



Summary of How We Got Here

April '07 Credit Crises



Housing crash



Consumer spending ↓



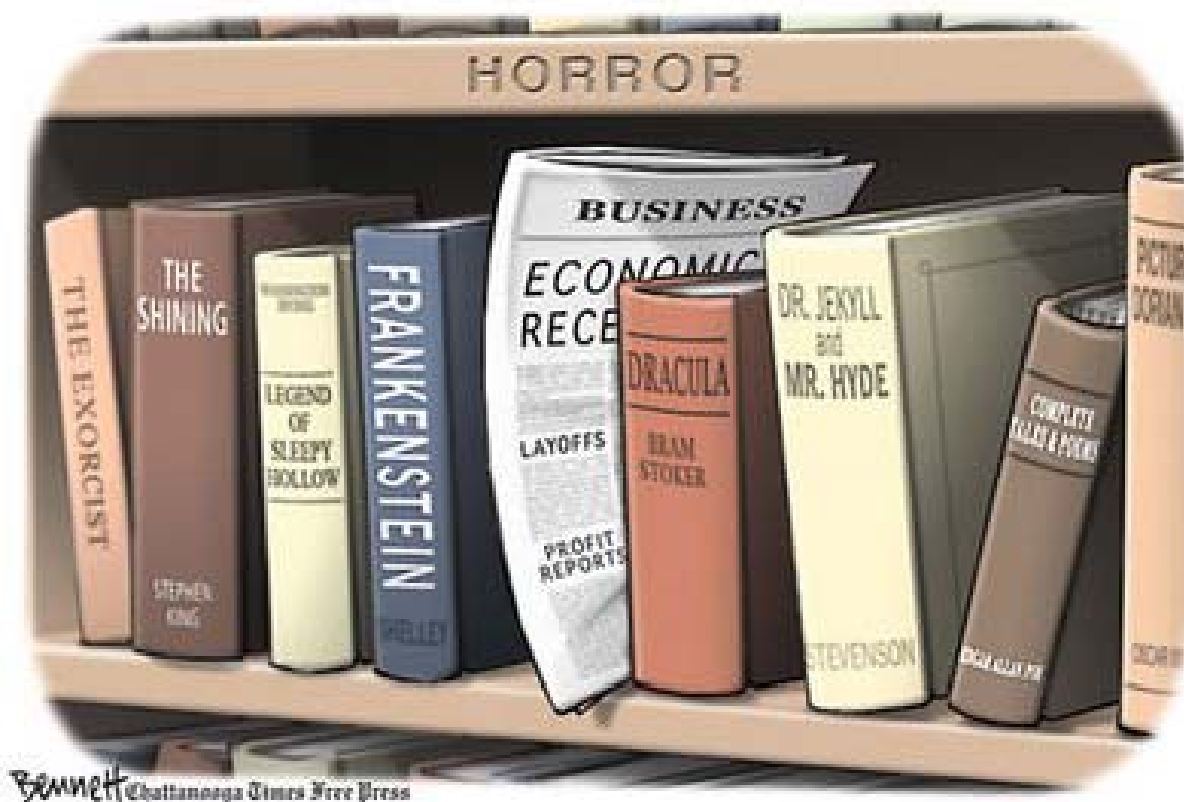
Econ fundamentals ↓



Vacancies in CRE

Why a CRE Bubble?

“We have seen this horror movie before,
so the end isn't that scary.”





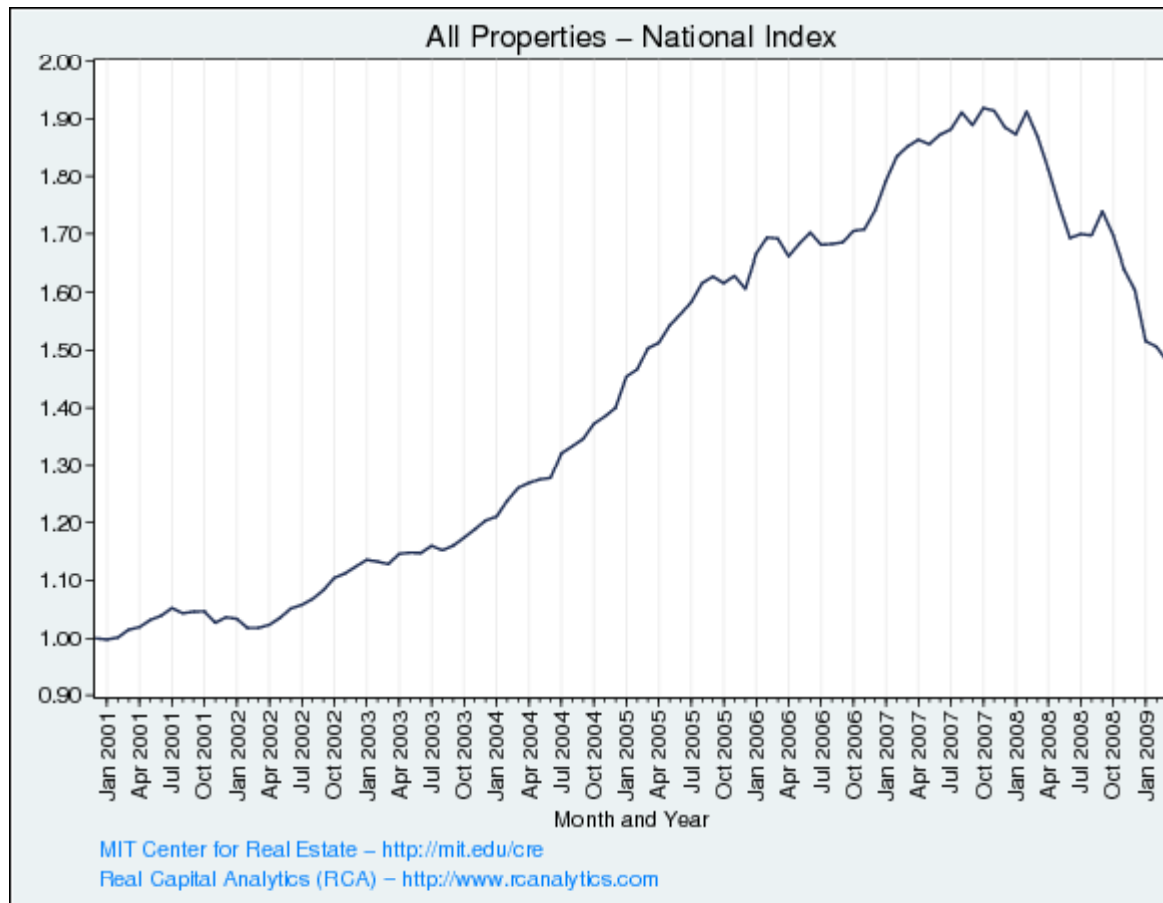
Status of CRE in Western U.S.

- Values down by 30% - 40%
- Values continue to decline
- Unwinding of bubble



Status of CRE in Western U.S.

All Asset Classes Plummeting



Western 11 states unemployment rates

State	Unemployment Rate Apr '09
Arizona	7.7%
California	11.0%
Colorado	7.4%
Idaho	7.0%
Montana	6.0%
Nevada	10.6%
New Mexico	5.8%
Oregon	12.0%
Utah	5.2%
Washington	9.1%
Wyoming	4.5%

Status of CRE in Western U.S.



Oakland, CA

Year	Owner	Price
2007	Developer	\$2.1M (\$330/SF)
3-2009	Lender	\$1.38M (\$184/SF)
6-2009	Lender	\$1.315M (\$175/SF)
Future Value		\$750,000 (\$100/SF)???



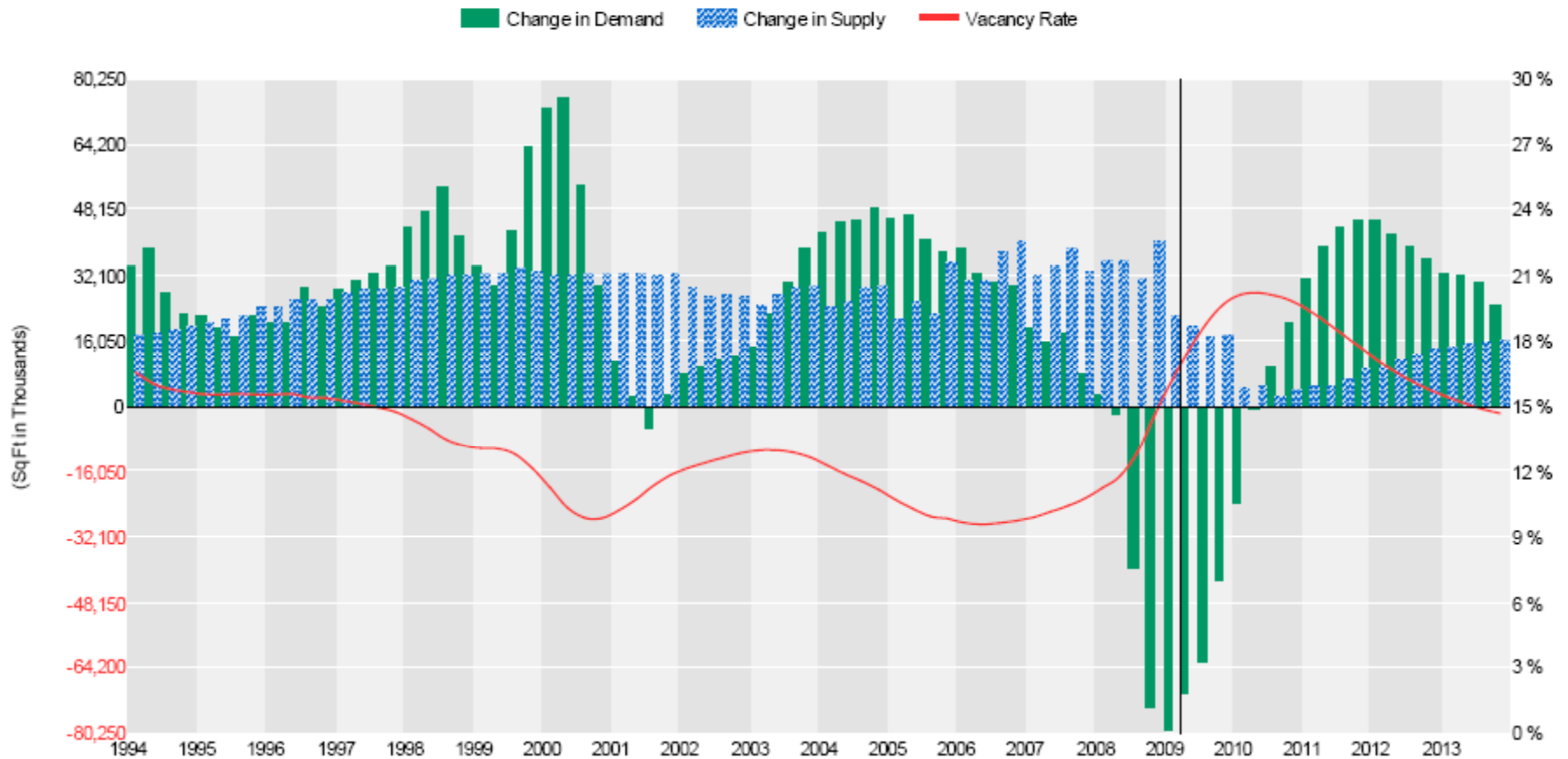
Status of CRE in Western U.S.

Recent retailer bankruptcies



Status of CRE in Western U.S.

Retail – Quarterly Supply, Demand and Vacancy As of 2009Q1



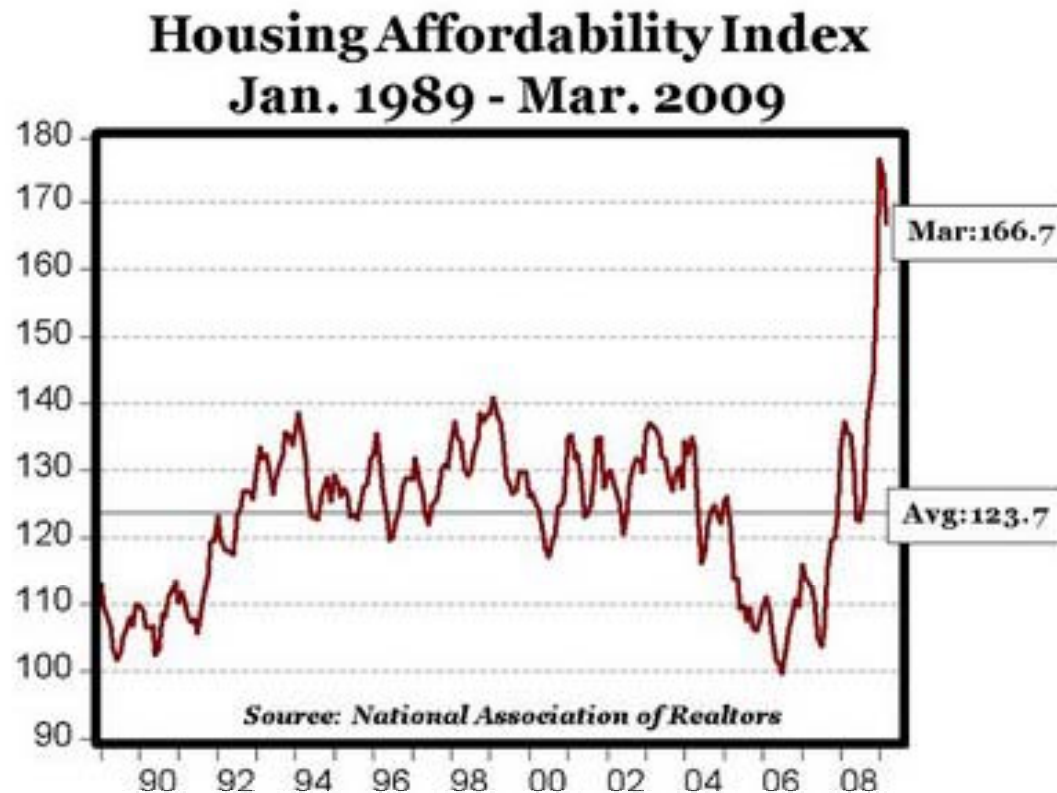
Source: Property And Portfolio Research, Retail Edition, June 2009



Status of CRE in Western U.S.

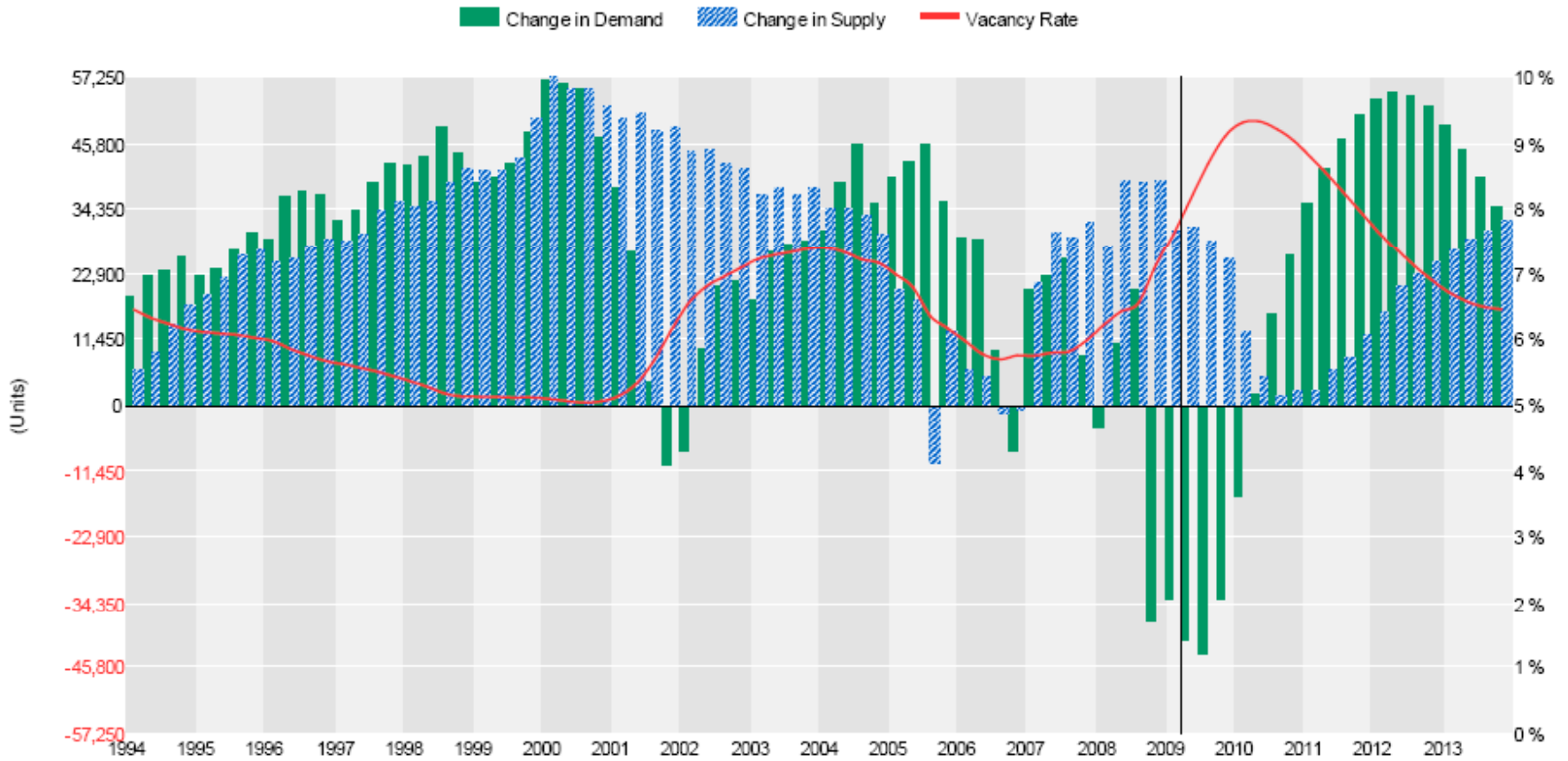
Multi Family

- National Housing Affordability Index



Status of CRE in Western U.S.

Apartments – Quarterly Supply, Demand and Vacancy As of 2009Q1



Source: Property And Portfolio Research, Apartment Edition, June 2009



Status of CRE in Western U.S. - Apartment Case Study



Long Beach, CA Apartment Complex

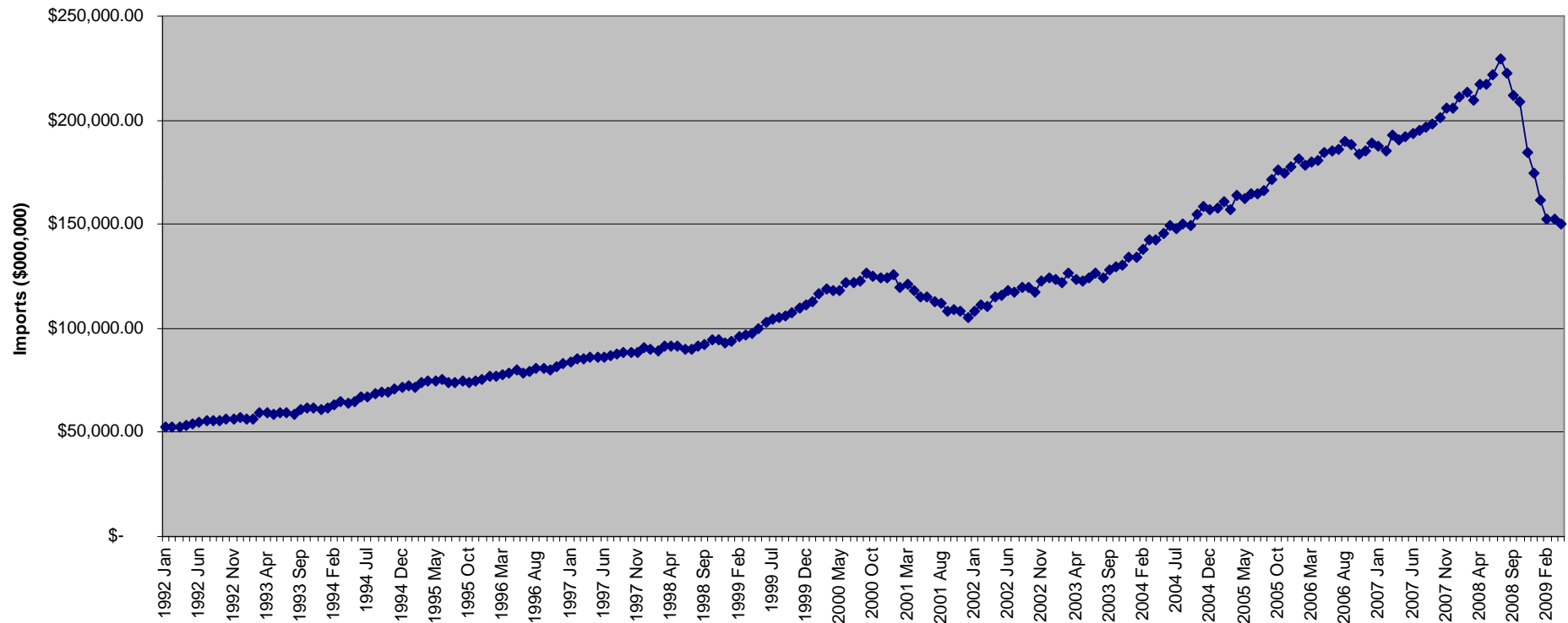
Year	Owner	Price	
2005	Local Investor	\$6.6M	\$120,000/door
2006	Local Investor	\$9.2M	\$167,000/door
2007	Lender	\$11M	\$200,000/door
2009	Lender	\$6.6M	\$120,000/door



Status of CRE in Western U.S.

Industrial

U.S. Imports ('92 - '09)



Status of CRE in Western U.S.



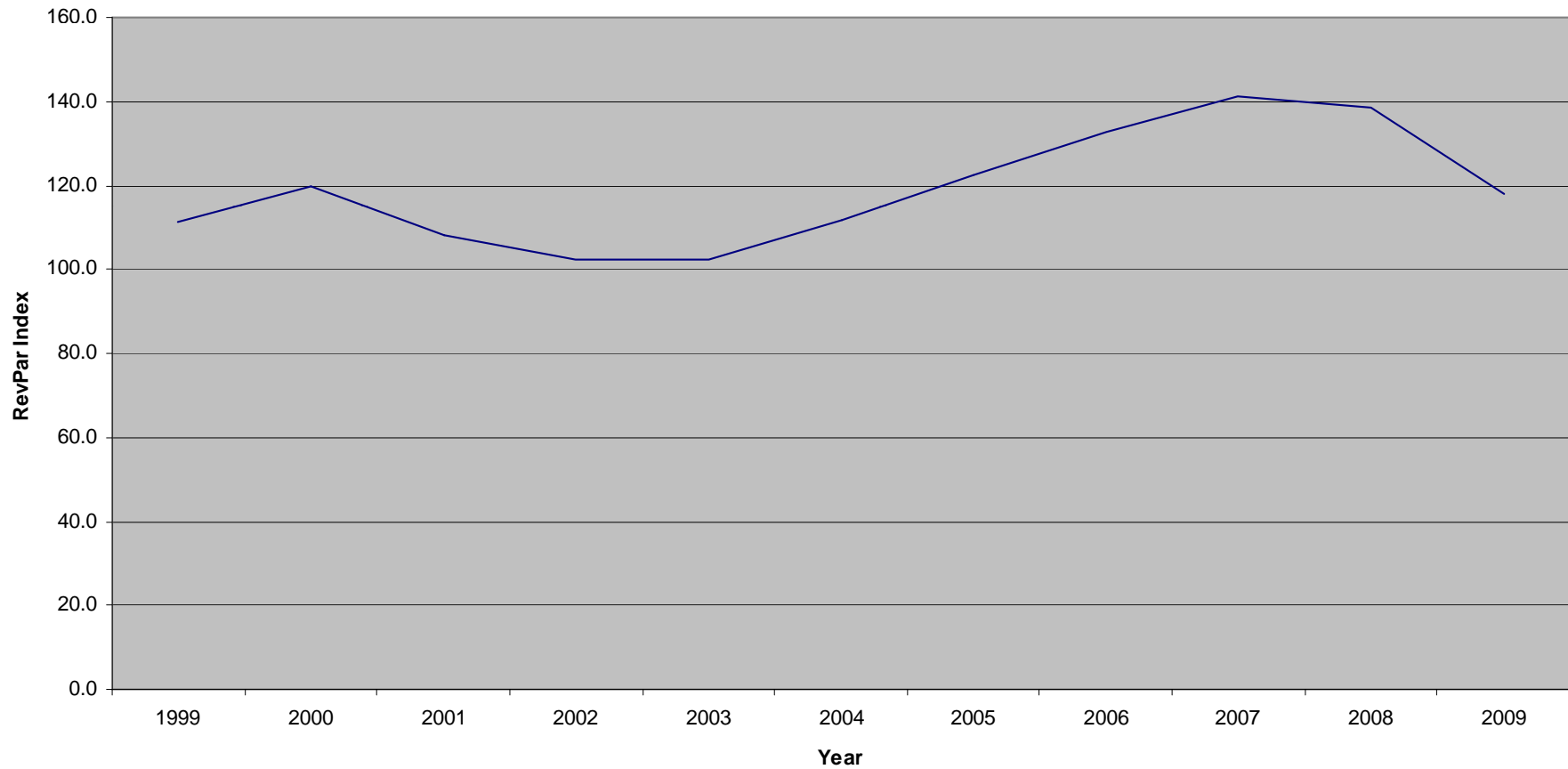
Vernon, CA
91,674 SF

- Lender carried back paper
- Listed at \$120/SF
- Price drop to \$109/SF
- Then to \$99/SF
- Sold for \$70/SF
- Previously sold 7/1/2003 for \$57.43/SF



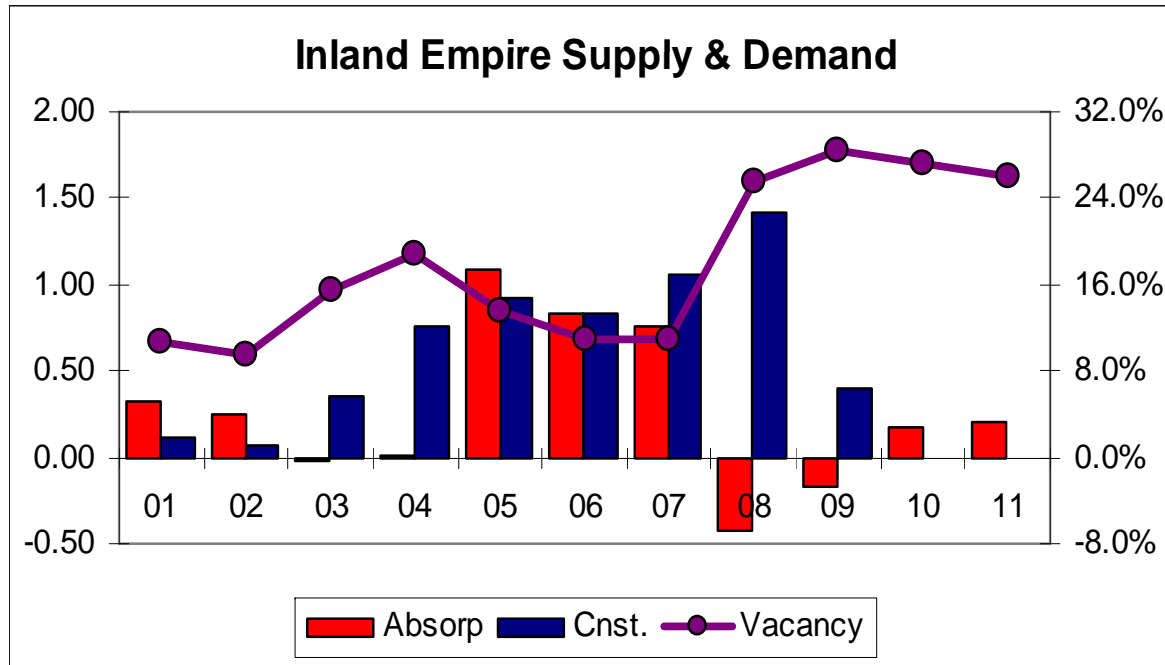
Status of CRE in Western U.S.

Hotel - National Rev/Par Over 10 Years



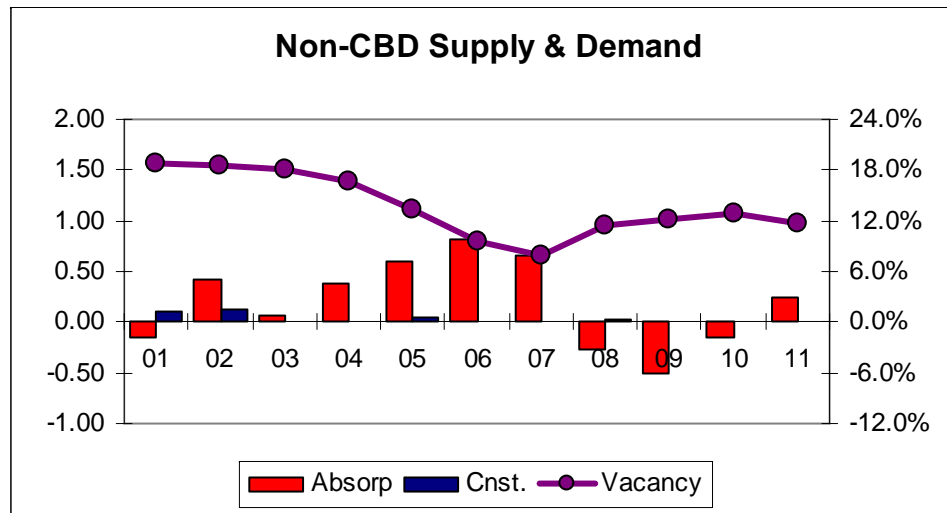
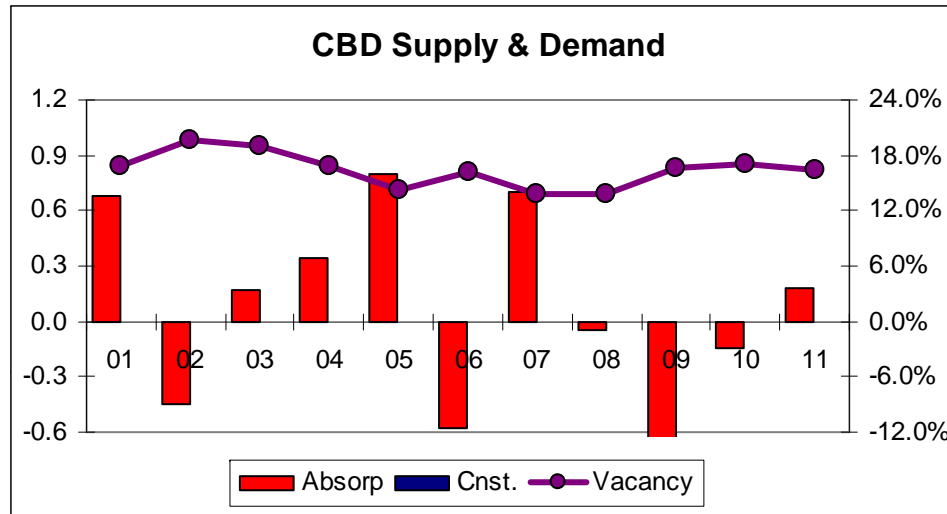
Status of CRE in Western U.S.

Inland Empire - Office



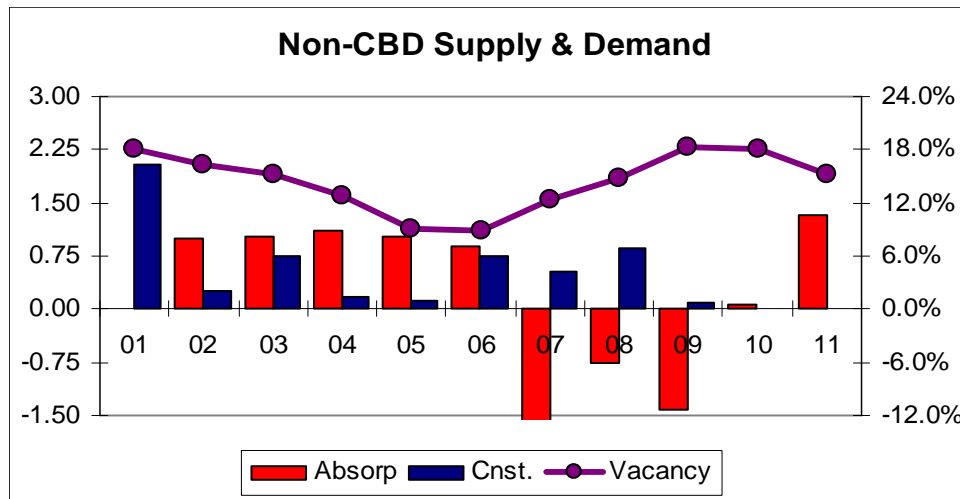
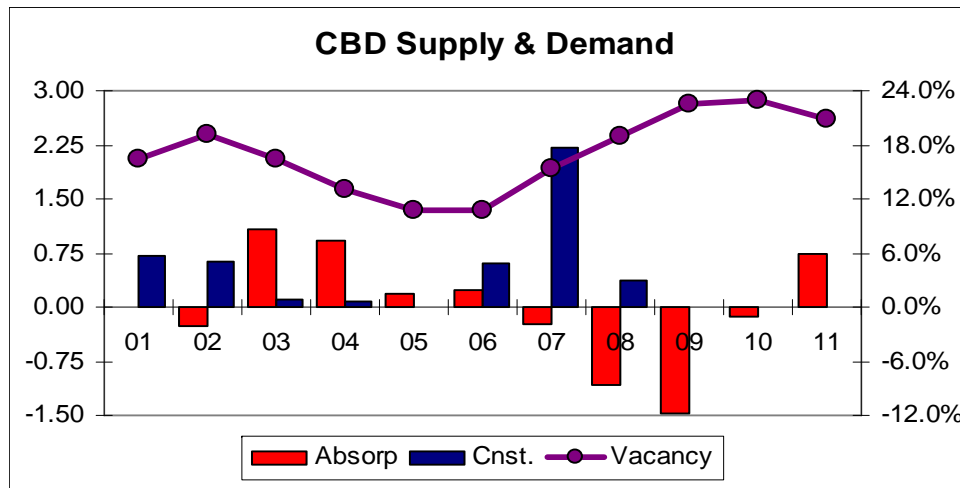
Status of CRE in Western U.S.

Los Angeles County - Office



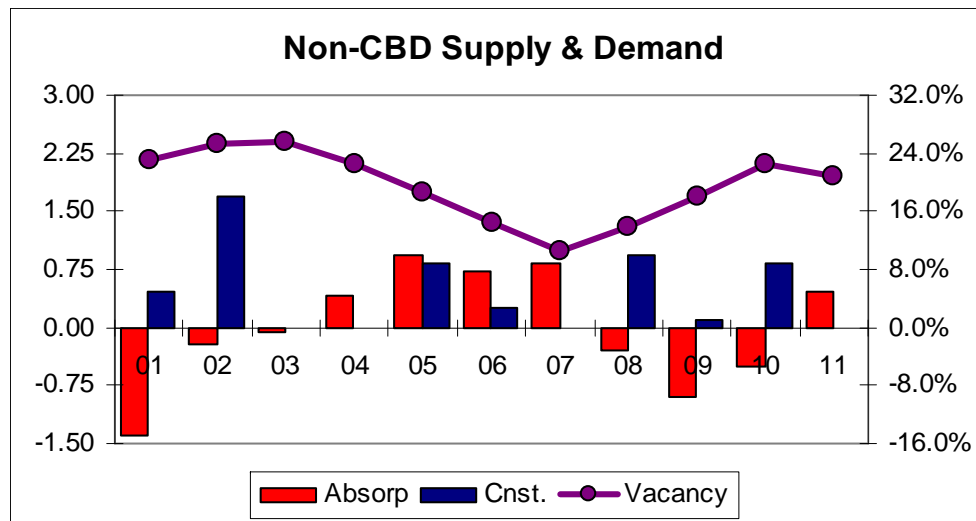
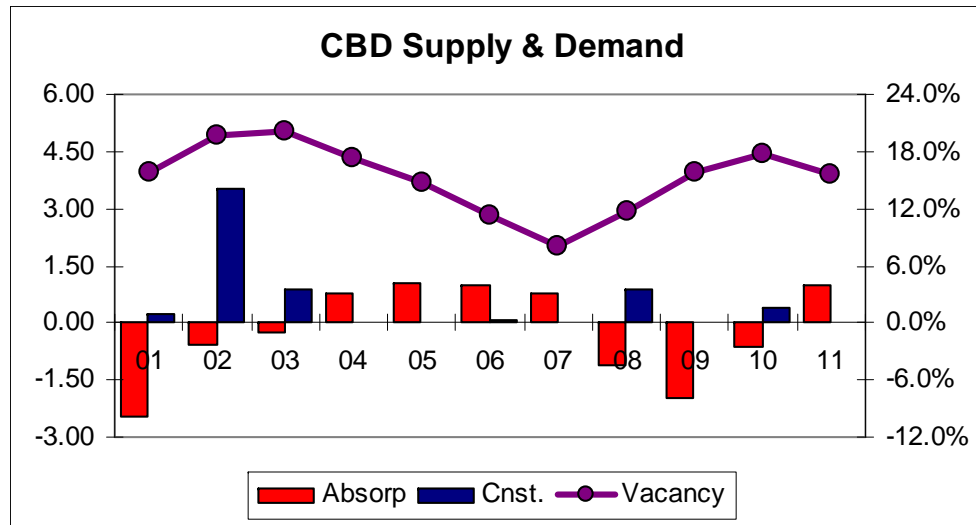
Status of CRE in Western U.S.

Orange County - Office



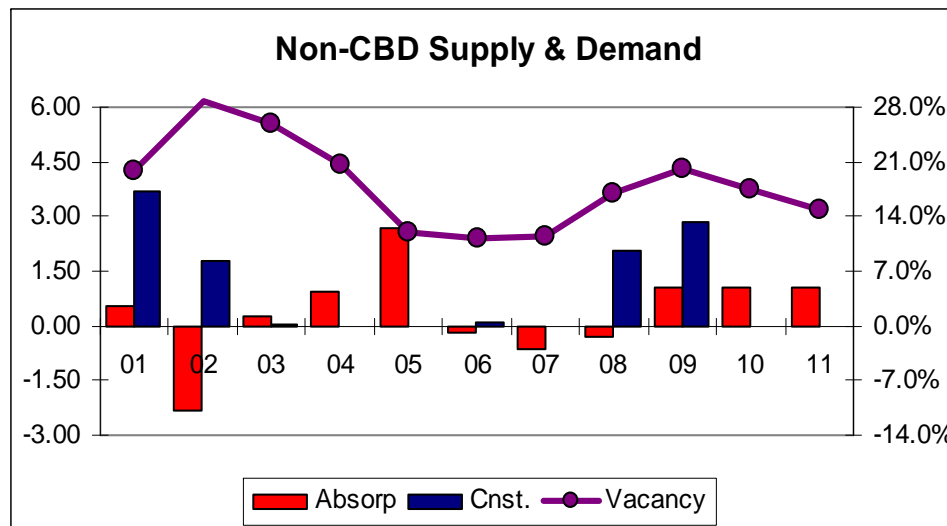
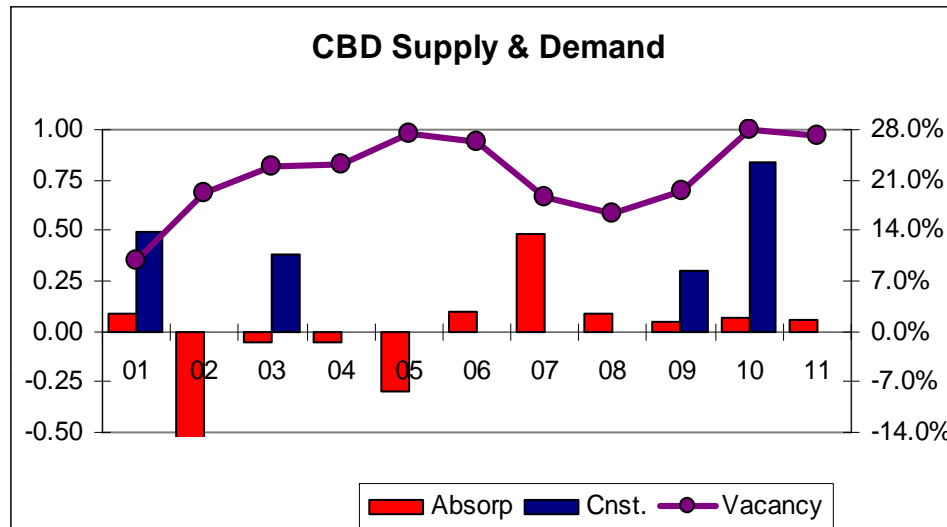
Status of CRE in Western U.S.

San Francisco - Office



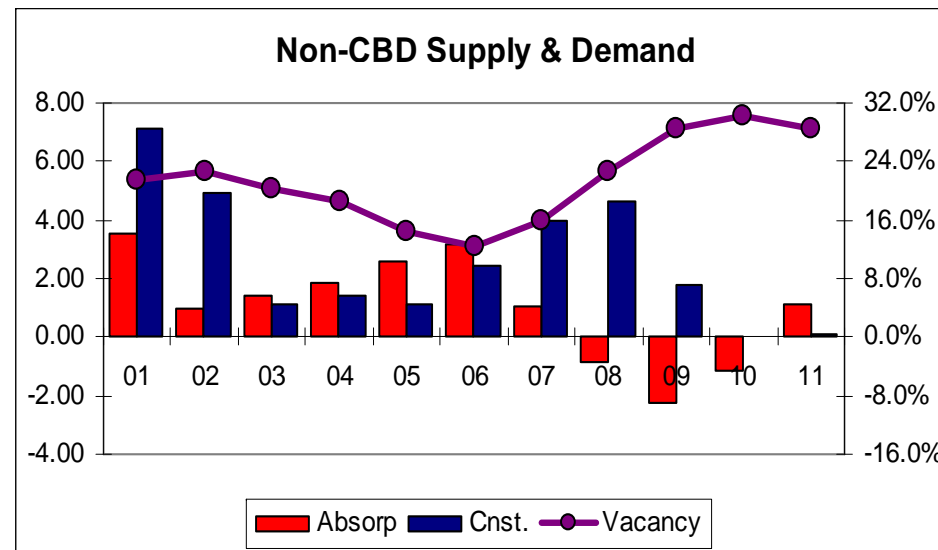
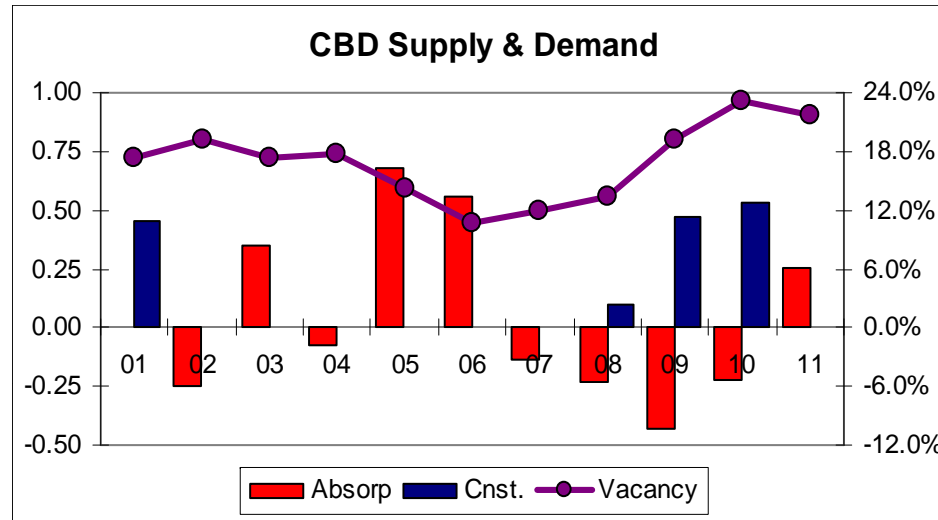
Status of CRE in Western U.S.

Silicon Valley - Office



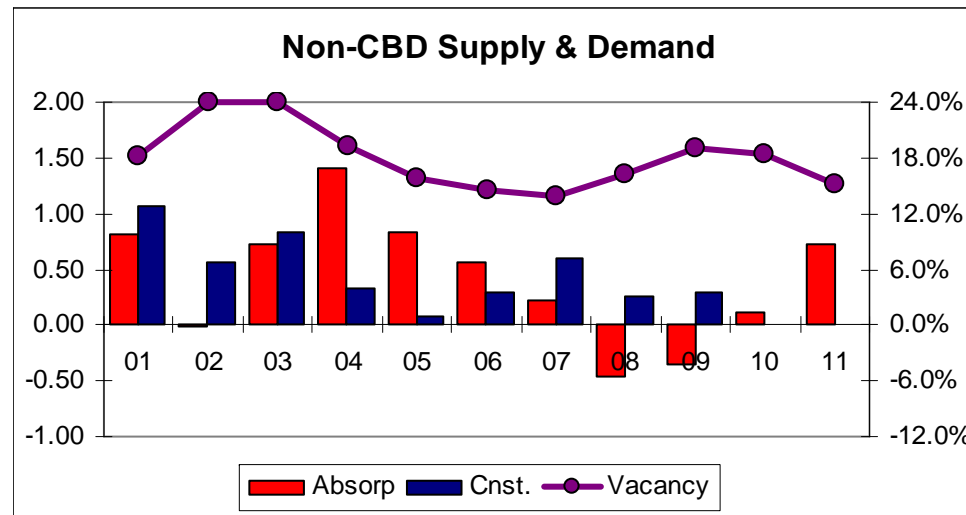
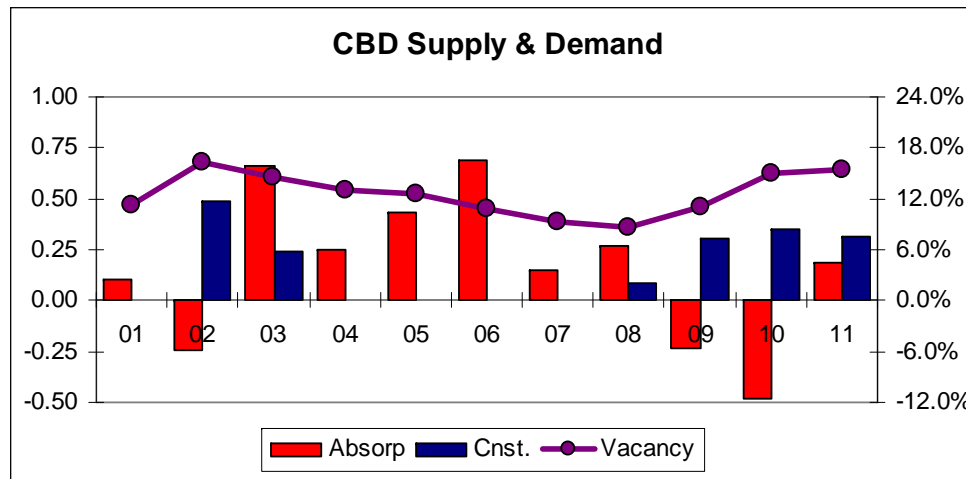
Status of CRE in Western U.S.

Phoenix - Office



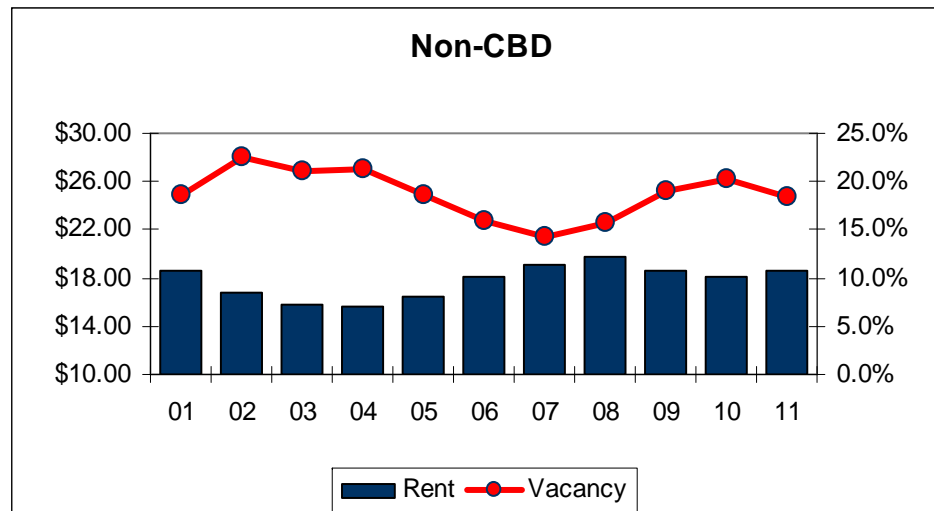
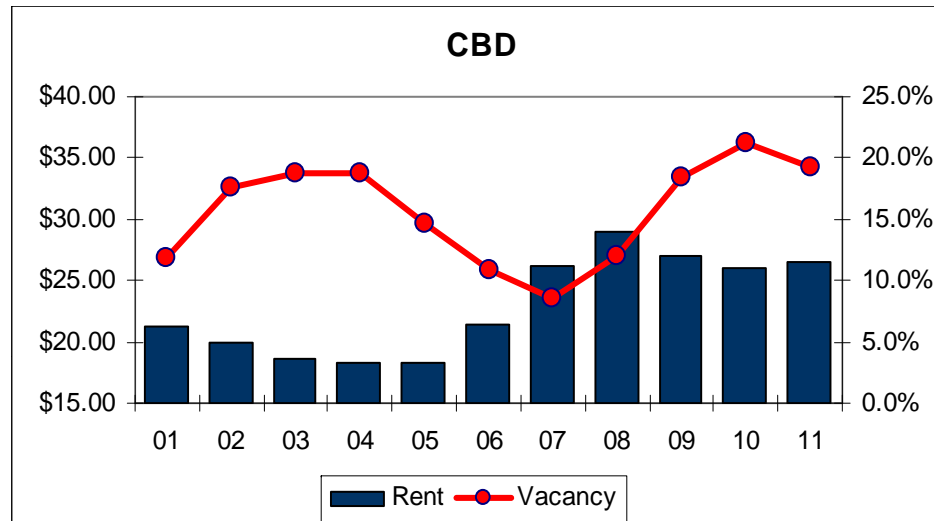
Status of CRE in Western U.S.

Portland - Office



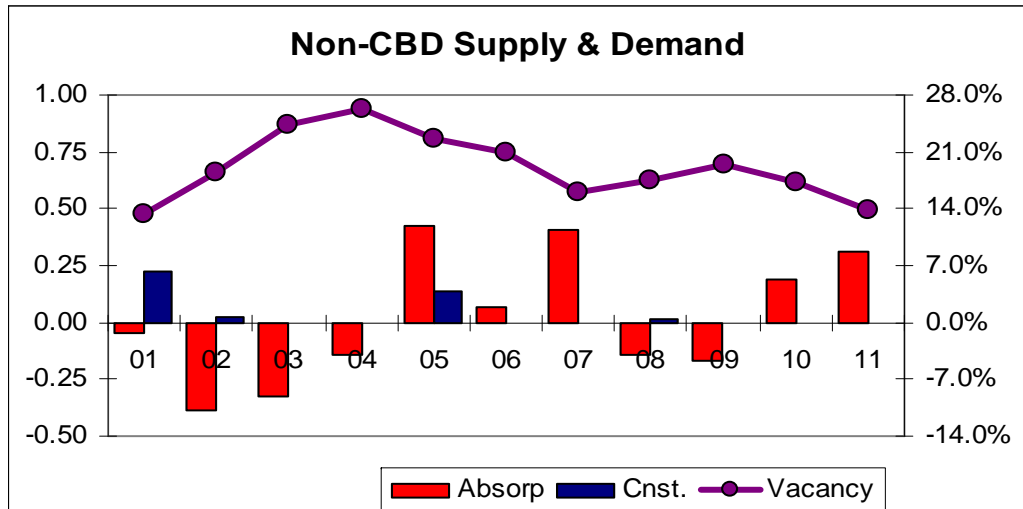
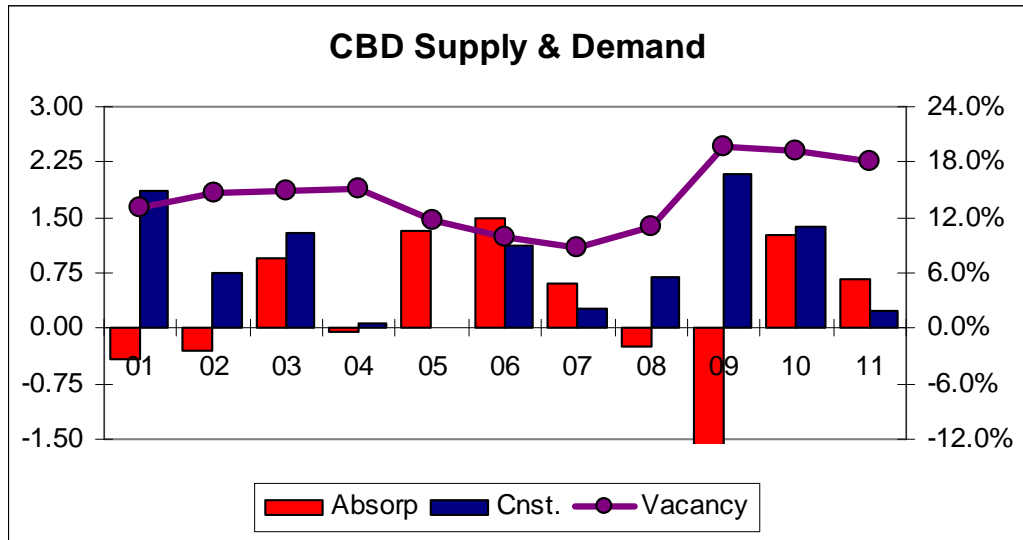
Status of CRE in Western U.S.

Denver - Office



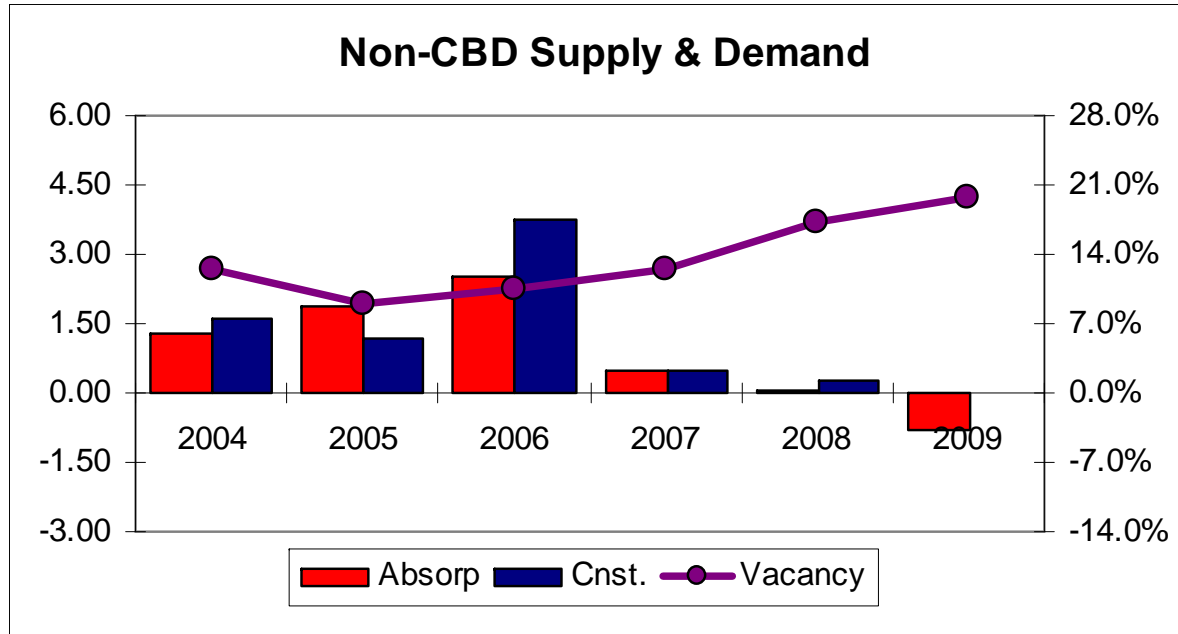
Status of CRE in Western U.S.

Seattle - Office



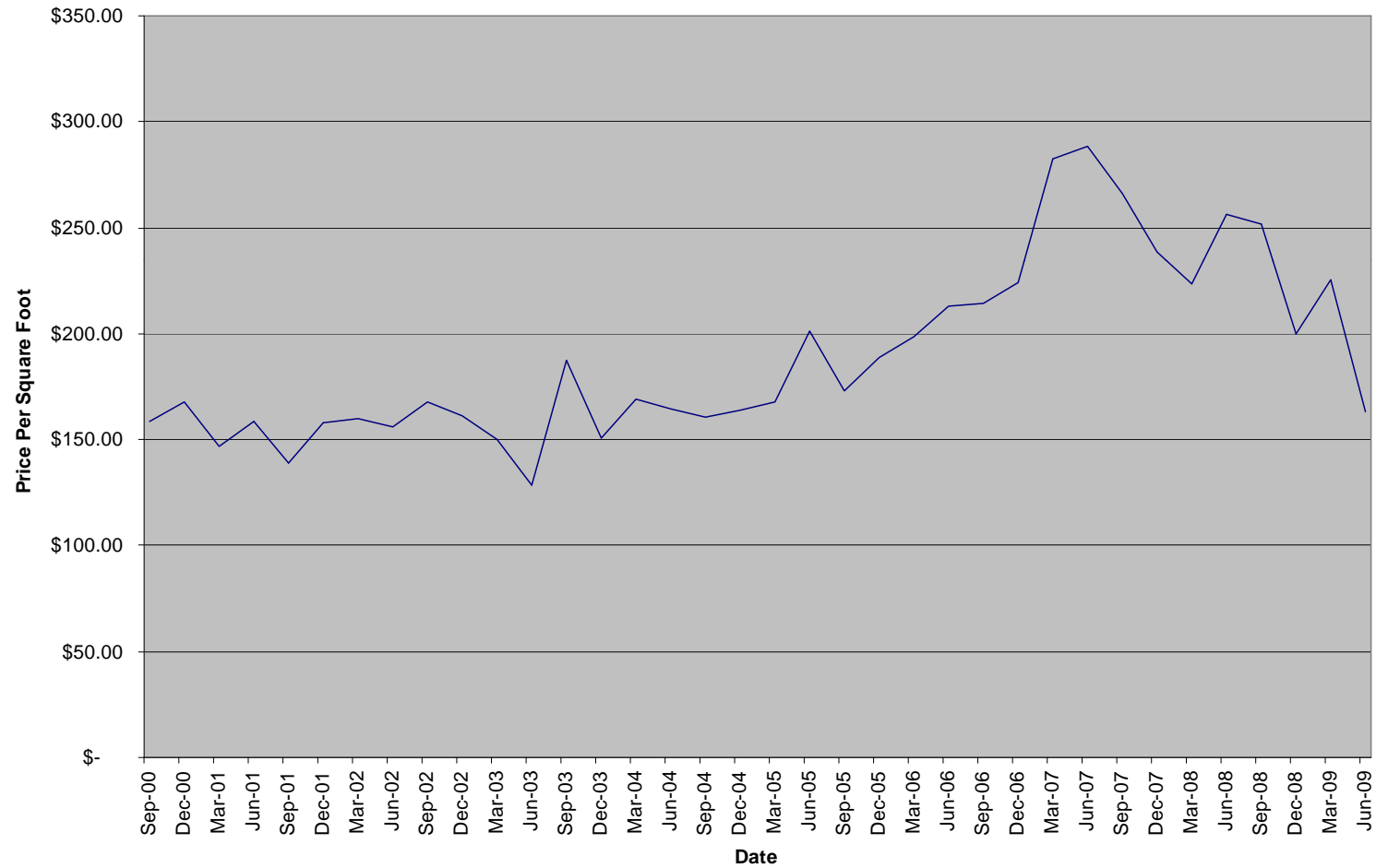
Status of CRE in Western U.S.

Las Vegas - Office



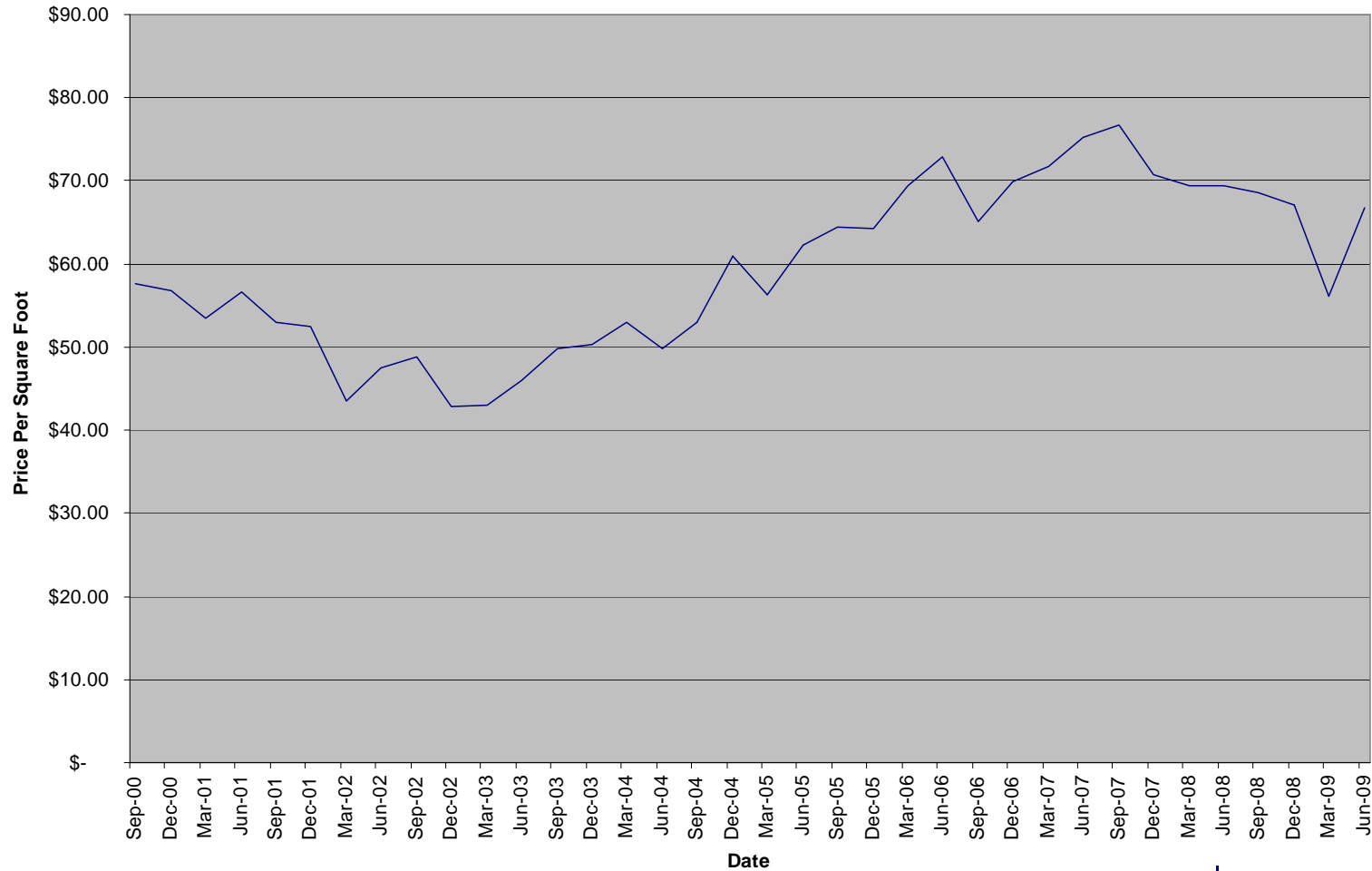
Status of CRE in Western U.S.

National Historic Office Prices



Status of CRE in Western U.S.

National Historic Warehouse Prices



Summary of Current CRE Markets

- If new construction in submarket = Meltdown
- Very slow leasing
- Rapid rent deflation
- Mostly “forced” sales



CRE Forecast

Short Term:

- Forced sales
- Substantial price correction
- Massive foreclosures/
cramdowns
- CRE default rate should
double



Long Term:

- Market will drop in excess of fundamentals (overshoot) due to forced sales by troubled owners/lenders.
- This will create HUGE OPPORTUNITIES FOR THE BRAVE (AND RICH). Cash is king.
- 10 years cycle – 5 up, 5 down (we only have 7 year memories, so always overshoot)
- New, entrepreneurial companies will sprout

Protracted/Anemic Recovery

- Output gap closed in 3-4 years, CRE follows
- 2% annual GDP growth in 2010
- Wall Street flat, removes fuel from corporate growth
- CRE debt financing difficult to obtain

Challenges to Recovery:

- Political risk – taxes, changing rules
- State budgets
- High inventory levels
- Permanently decreased corporate footprints (Starbucks)
- Special Servicers

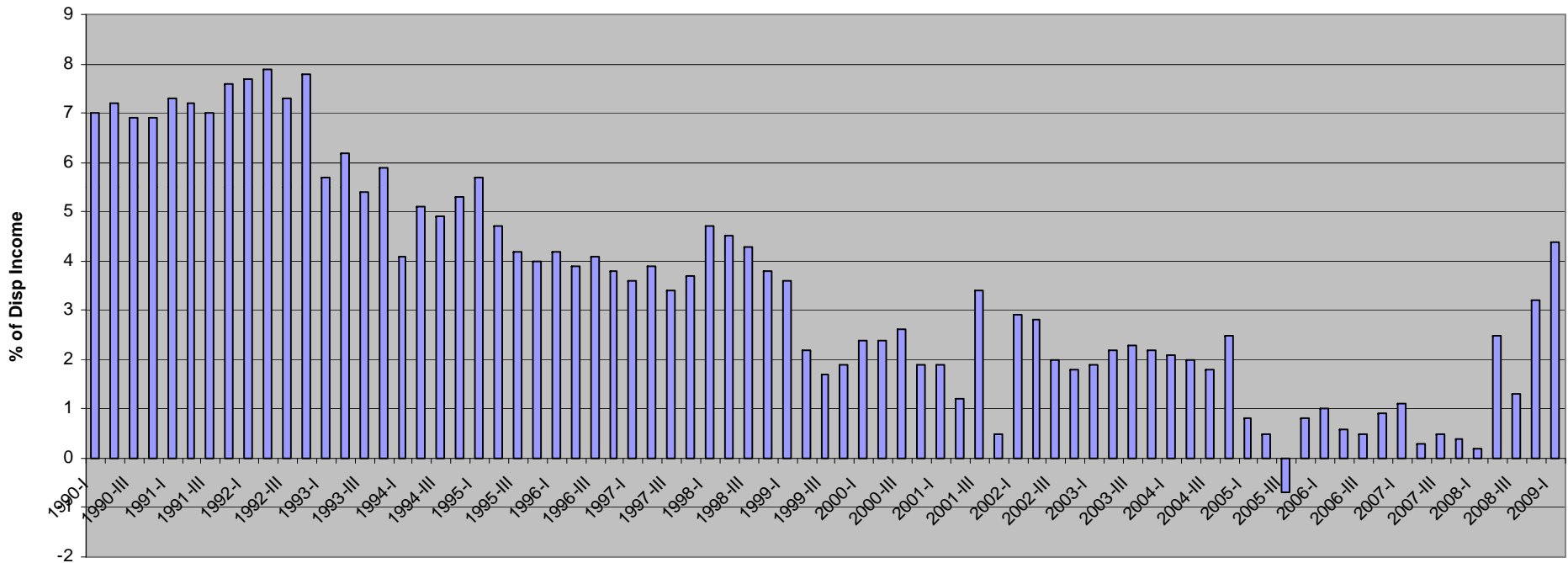
Special Servicers

- Inflexible
- Can't work out/extend
- Causes foreclosures
- Resultant fire sales drop market

What's required for a recovery

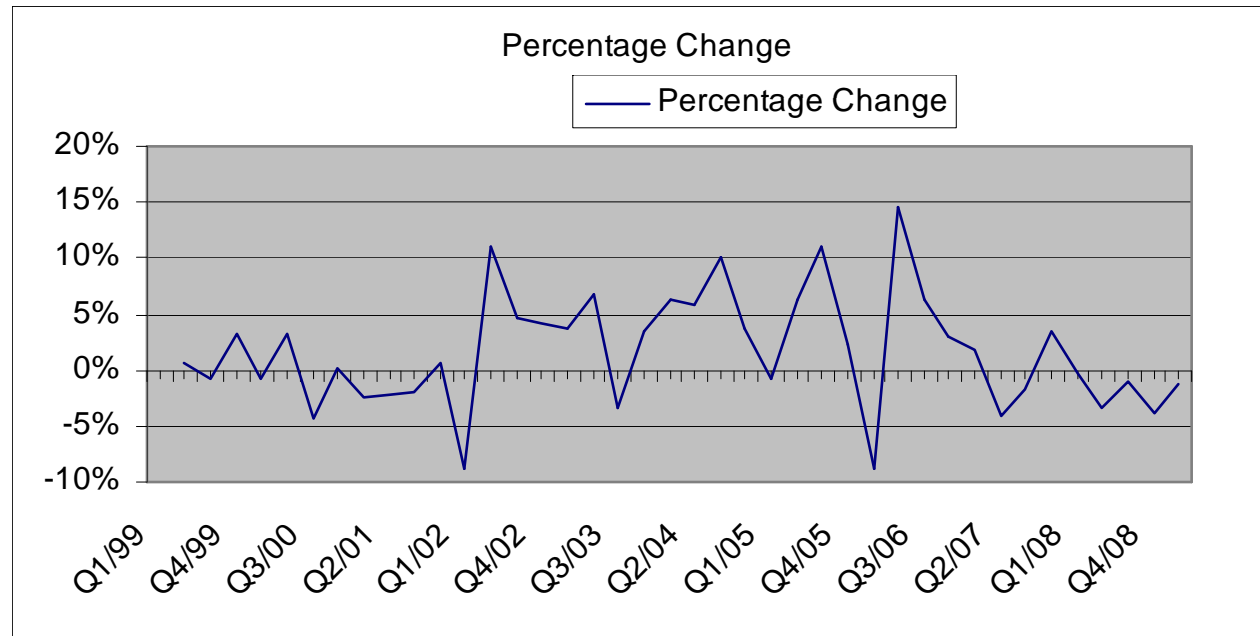
- Profits/Hiring
- Continued low IRs/low inflation
- Lending
 - CMBS spreads drop 300 bps
 - TALF? No closed deals
- Consumer Spending

U.S. Personal Savings Rate



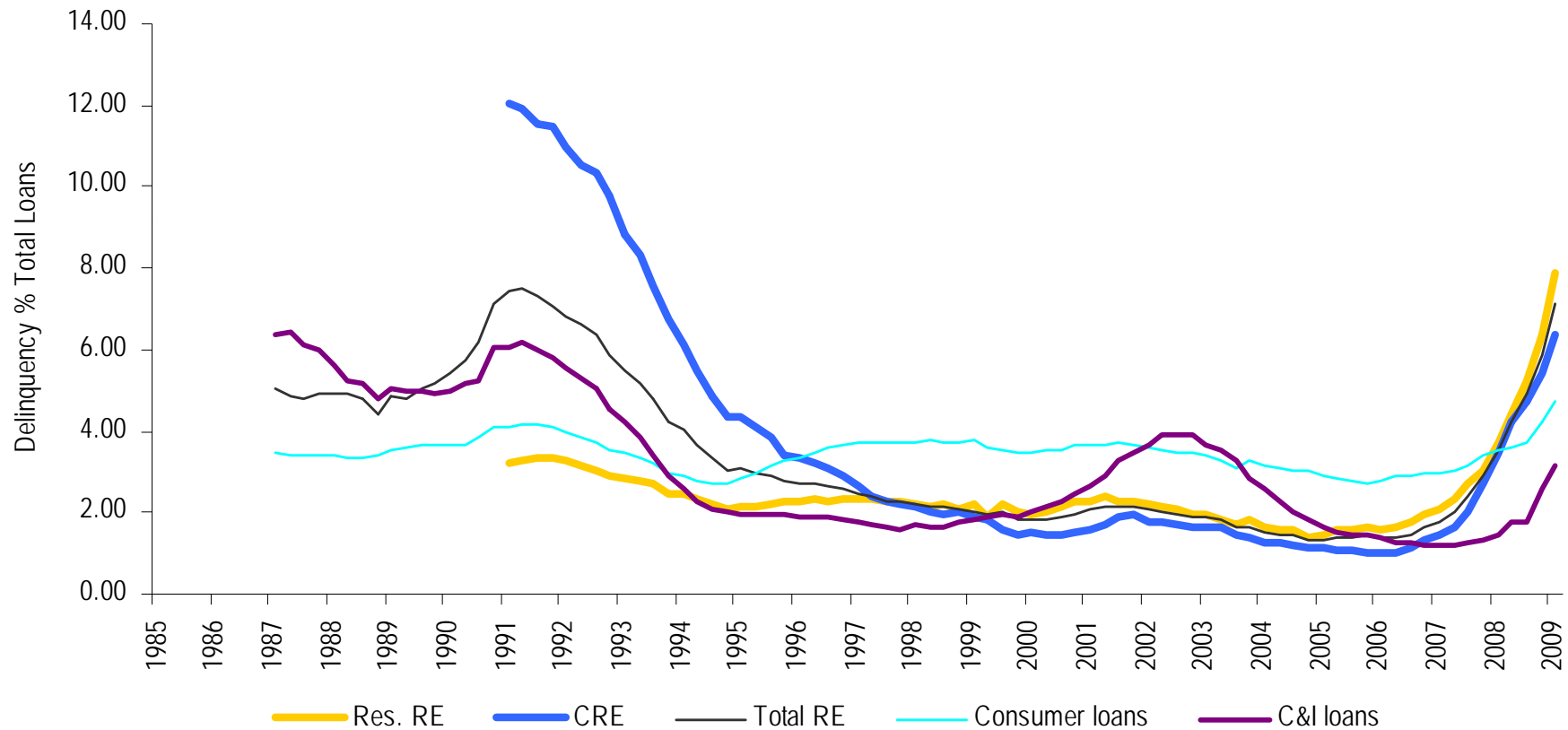
Need consumers to spend again: 8%

Corporate Profits



- U.S. firms end streak of quarterly declines (6 quarters)
- No hiring without profits
- Profits key to recovery

Delinquency Rates as % Total Loans



Source: Federal Reserve, through 1Q09

Indicators of Recovery:

- Unemployment slowdown
- Positive absorption
- Continued low interest rates
- CMBS spreads narrow to 250 bps from current 450-550
- Sales volume uptick
- Equity raises
- Public company share prices



MSCI Barra REIT Index



The Good News:

- Healthcare and infrastructure spending will be bright spot
- The employment of the currently unemployed will point way to recovery
- Natural economic process
- Watch them! They will point the way!