September 14, 2009

High-Profile Loan Defaults Put Institutional Investors Under Microscope

It has been a cruel summer for several of the nation's largest and most respected institutional investors when it comes to the commercial real estate market. A combination of rising loan defaults, deteriorating property fundamentals and the long-term prospect of higher interest rates in the wake of massive fiscal and monetary stimulus is testing their fortitude. In August, Tishman Speyer Properties defaulted on loans associated with the acquisition of 28 Washington, D.C.-area office buildings for $2.8 billion from the Blackstone Group in 2006. Blackstone sold the portfolio to Tishman at the height of the market, the same month it purchased CarrAmerica, the portfolio's previous owner. Tishman also owns Rockefeller Center and the Chrysler Building in New York and controls assets worth an estimated $35 billion. Also in August, the California Public Employees' Retirement System, or CalPERS, the nation's largest pension fund, defaulted on a $70 million mortgage note it signed in 2007 with partner CommonWealth Partners LLC on the KOIN Center, the tallest office tower in downtown Portland, Ore. A receiver has been appointed for the property at the request of mortgage holder New York Life Insurance Co. The CalPERS-CommonWealth partnership purchased KOIN Center for $109 million in 2007. In July, a partnership between CalPERS and Houston-based developer Hines defaulted on a $152 million mortgage secured by three office buildings in Emeryville, Calif., just across the bay from San Francisco. The buildings, totaling 814,000 sq. ft., are part of the 1.2 million sq. ft. Watergate office complex. NOP Watergate LLC, the joint venture involved in the default, paid $335 million for the buildings and a separate restaurant in late 2006, at what most observers consider to be the height of the market. Now it is surrendering the property to the lender, Pacific National Bank. CalPERS and other large institutional investors are not running out of cash, but they are cutting and running as property values have continued on a downward spiral. CalPERS controls real estate assets of $17.9 billion as of September 1, 2009, but saw the value of its real estate portfolio dive by 35.8% year over year in the latest reporting period ended March 31. That marks the largest value decline in the fund's history. Not to be outdone, in late August, the California State Teachers' Retirement System or CalSTRS, reported a huge loss on its real estate assets, with values declining 35% to $12.9 billion in the 12 months ended March 31, 2009, the latest reporting period available. Flagging valuations largely stem from a dearth of property sales, but compounding the problem is a deterioration of property fundamentals. More office tenants are taking a wait-and-see approach to their space needs and many are downsizing, forcing vacancy rates higher and rental rates lower. For now, things are likely to get worse for institutions before they get much better. "Given where we are in the cycle, this could mean deteriorating fundamentals for another 12 to 18 months," says Victor Calanog, director of research at Reis in New York. According to Sam Chandan, president and chief economist with researcher Real Estate Econometrics, more than $200 billion of commercial mortgages are maturing before the end of 2009. "We're going to face a real challenge in keeping delinquency and default rates for commercial mortgages down and making sure that it doesn't impact the performance of the financial services sector," says Chandan. The potential for default, however, is widespread. "If you took every property in the market right now that has leverage on it and marked it down by 60% or 65%, almost every office property borrower in this country who leveraged their properties or bought a property between 2006 and 2008 is going to find themselves under water, and each of those mortgages faces the potential for default," says Chandan.

Managing through increasing vacancies and lease rollover negotiations will be key. And institutions may turn to service providers to help them through the coming mess. "We're pursuing a lot of property management business," says Steven Pumper, executive managing director with Transwestern in Dallas. Institutional owners have another worry on their hands, inflation. Many observers see higher inflation as a distinct possibility over the next few years, and while a little inflation helps prop up valuations and revenue, too much could put further pressure on financing. "Higher inflation also implies higher interest rates on mortgages that are renewed," says Chandan. "If interest rates are higher, then the fundamental problem that we have in commercial real estate right now actually becomes a more challenging one." If owners are hoping for any easing in credit standards ahead, they aren't likely to get it. According to the Federal Reserve's latest survey of senior loan officers at major banks, lending standards will remain tight until at least the second half of 2010. Plus, New York rating agency Fitch says that troubled commercial real estate loans are dragging down the health of the nation's banks. 'The performance metrics of commercial real estate (CRE), an area with a significant risk exposure for the majority of Fitch's U.S. bank universe, continues to deteriorate at an unprecedented pace," noted a recent report. Defaults on loans structured as commercial mortgage-backed securities (CMBS) are another worry. CMBS loan delinquencies breached 3% in July and are expected reach at least 5% by year's end, according to Fitch. Expectations for returns on investments will need to be scaled back to historical averages, and holding periods will likely increase, says Calanog. "Cash flow and its fundamental determinants, once the hallmark of commercial real estate returns, will once again become a larger portion of total returns." In short, the future is likely to look like the past, but not the recent past, adds Calanog. "With capitalization rates, underwriting criteria, and lending standards all trending back toward historical mean levels, the second decade of the 21st century may look more like the 1990s and less like the 2000s." **(National Real Estate Investor/Ben Johnson)**

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Colorado Businesses Chasing a New "Green"

Architect's rendering of 1800 Larimer, a pre- certified LEED Platinum building in LoDo. (The Denver Post)When Xcel Energy opted to fork over thousands of extra dollars in rent each month to land new energy-efficient office space in Lower Downtown Denver, it was an affirmation that going "green" is today's business mantra. Companies are hot to position themselves in buildings certified for their energy efficiencies — "green" in enviro-speak and "LEED" in business gab — in part to score valuable marketing points with key clients. "We did this with a substantial amount of enthusiasm, even though this is painful financially," said G.E. Buenning, branch manager at Colorado Financial Partners LLP in Lakewood, which sprinted to rent space across the street, despite its own lease lasting another six months. The 8,000 square feet of LEED space at the Signature Centre in Lakewood was simply too good to pass up, Buenning said. "I just knew this space wouldn't become available again," he said. Going green may well be the environmentally correct thing to do, but it's also of critical importance in today's business world to look good while you're doing it. "Traditionally, commercial real-estate value has been based on rental rate, level of amenities and location," said Rich Von Luhrte, president of Denver architecture firm RNL, which has designed a number of green buildings worldwide. "You've got value created by sustainability and the building's operating cost," he

said. The question naturally becomes: Can the market support the higher lease rates that go with developing a LEED — Leadership in Energy and Environmental Design — project, the most recognized seal of approval for green buildings? Some tenants are willing to pay the premium for office space that's more energy efficient, has better air quality and natural light. All of that appears in the LEED designation. When Xcel leased 330,000 square feet of office space at 1800 Larimer, a pre-certified LEED Platinum building under construction in Lower Downtown, it had to take on an average asking-lease rate of $34 to $36 a square foot — far more than the average for non-green spaces. "The LEED Platinum was very desirable," said Noel Mattison, project director for Xcel. "It further demonstrates our commitment to environmental leadership." LEED is a point-based system where building projects are graded for satisfying specific green-building criteria in six categories. Platinum is highest, gold next, then silver. The U.S. Green Building Council, a nonprofit organization that administers the LEED-certification program, recently launched a program requiring newly constructed buildings to provide energy and water bills for the first five years of operation as a condition of certification. Certification can be revoked if the data are not produced. While the perception is it's more expensive to build green, costs can be diverted from elements such as expensive exteriors and finishes to under-floor air-distribution systems, higher windows for natural light and waterless urinals. "We've never been one to embrace the environment or embrace sustainability unless there was legitimate payback," said Rich McClintock, president of Westfield Co. Inc., which owns 1800 Larimer. The market appeal has been clear. When Aardex developed the Signature Centre, the market sat at 15 percent vacancy. Still, the company leased the 300,000-square-foot building five months before it was completed — and for nearly double the going rents of surrounding buildings. "When we announce a vacancy, it's snapped up immediately," Aardex chief executive Rick Butler said. The average lease rate for space in a LEED-certified Class A building in the metro area is $29.23 a square foot, compared with $24.78 for a non-LEED Class A building, according to CB Richard Ellis. While many companies have jumped on the sustainability bandwagon, real estate brokers are coming to it more slowly, said Tom Lee, senior managing director of Frederick Ross Co., who is marketing 1800 Larimer, where Xcel leased space. "Brokers still don't get it," Lee said. "Brokers are all about rate, and the green aspects have taken a back seat to the economics." Xcel is paying about 5 percent more than it would in another building, Mattison said, largely because of the under-floor air-distribution system. The energy savings will pay off the added expense within four years. A study last year by the New Buildings Institute found LEED-certified buildings, on average, performed up to 30 percent better than non-LEED buildings in terms of energy use. Gold and Platinum LEED-certified buildings — the best available — have average energy savings of nearly 50 percent. **(Denver Post)**

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Fed Survey Shows US Recession May be Over

The recession is ending and the economy is finally growing again. That's the message implicit in the Federal Reserve's latest survey of businesses around the country, which found economic activity stabilizing or improving in most regions. Economists warn the expansion is fragile and will have staying power only if consumers start spending more money. Rising unemployment that keeps Americans

cautions could make for a plodding recovery in the months ahead. All but one of the Fed's 12 regions indicated economic activity either was "stable," showed "signs of stabilization" or had "firmed," according to the Fed's survey. The one exception was the St. Louis region, which reported the economic decline is "moderating." Businesses in most Fed regions said they were "cautiously positive" about the economic road ahead. The survey, known as the Beige Book, does not include precise figures. Analysts predict the economy is growing in the current quarter, which ends Sept. 30, at an annual rate of 3 percent to 4 percent. That's mostly because businesses, which had slashed investments during the recession, are spending more. Auto sales have been lifted by the government's recently ended Cash for Clunkers program. Manufacturing and the battered housing market, which led the country into recession when it collapsed, have also shown signs of improvement. The problem for the economy is that the expected growth this quarter comes mainly from the auto companies and other manufacturers, which are refilling their depleted stockpiles. Those inventories had dwindled as factories and retailers sought to bring what they had more in line with reduced sales. Any robust growth in the economy might be short-lived if shoppers don't step up their spending. In the Fed survey, most regions of the country reported that the clunkers program had boosted sales. Other merchants struggled. And consumer spending remained soft in most places. Still, the assessments of businesses on the front lines of the economy were brighter than those they provided for the last edition of the Fed survey in late July. At that time, most regions of the country reflected only that the recession was easing its grip. "That's a pretty significant change in tone from the previous Fed report," said Brian Bethune, economist at IHS Global Insight. In Wednesday's survey, the Dallas region indicated that economic activity had "firmed." The Fed regions of Boston, Cleveland, Philadelphia, Richmond and San Francisco mentioned "signs of improvement." The Atlanta, Chicago, Kansas City, Minneapolis and New York regions described activity as "stable or showing signs of stabilization." The survey's findings will figure into discussions when Fed Chairman Ben Bernanke and his colleagues meet Sept. 22-23. The Fed is expected to keep interest rates at record lows, probably for some time, to help nurture the recovery. "There are presently some signs that the economy is stabilizing and even reviving in certain areas, despite mixed signals," Richard Fisher, president of the Federal Reserve Bank of Dallas, said in a speech in Texas. In most regions, manufacturers reported "modest" improvements. In and around San Francisco, orders rose for semiconductors. Richmond, Atlanta, Chicago and Minneapolis reported increases or planned increases in automobile production. Several regions noted more production for prescription drugs. The market for homes is still is still weak—though it flashed some signs of improvement. In most places, buyer demand was stronger for cheaper homes, and in and around Philadelphia sales were up for more expensive homes, too. Fed regions credited a tax incentive for first-time home buyers with increasing sales. Home prices kept falling in most parts of the country, though in the Dallas and New York regions, the survey found prices "firming." In a sign that lenders' efforts to help troubled mortgage holders may be helping, the number of U.S. households threatened with losing their homes held steady last month, RealtyTrac Inc. reported Thursday. The number of foreclosure-related filings—including default notices, scheduled auctions and bank repossessions—remains 18 percent higher than a year ago. There was plenty of bad news in the survey. In the commercial real estate market, demand stayed weak, and construction fell in all parts of the country. And the job market was still sickly all over the nation. The nation's unemployment rate, which stood at 9.7 percent in August, could top 10 percent this year. Fisher, of the

Dallas Fed, called for "uncomfortably high unemployment" as businesses keep cutting costs. After the sudden growth expected in the current quarter, many analysts expect the economy to slow a bit through the rest of this year and into 2010. The Fed's survey found that staffing companies in most of its regions saw a pickup in demand for temporary workers. That's an encouraging sign: Employers typically use more temp workers before they hire new employees. Still, several regions noted that businesses and local governments were imposing wage freezes or cutting compensation. With the labor market weak, employers are keeping a lid on wages and helping hold down any inflation, the Fed report said. Expectations for a lethargic recovery will probably keep companies from jacking up prices as well, the report suggested. **(Denver Post)**

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	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED FUNDS RATE	.25	.25	2.00
3 MONTH LIBOR	.30	.45	2.82
PRIME RATE	3.25	3.25	5.00
10 YEAR TREASURY	3.34	3.71	3.66
30 YEAR TREASURY	4.18	4.53	4.23