

The Economics and Behavior of Real Estate Recovery

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In January of this year, I read the Linneman (Real Estate) Letter, authored by my long time friend and colleague, Peter Linneman, founder of the Wharton Real Estate Center at the University of Pennsylvania. "Good news," he wrote, "The Recession is over." He continued by stating that the economy had bottomed out in April or May of 2009, nearly a year ago.

Today's Economy - Good News or Bad News?

But, I could not help but wonder: if the recession is indeed over, did someone forget to tell my tenants? My lenders? My Governor and my Mayor? My office tenants are laying off employees and contracting their leases; my retail tenants are losing customers as those laid off and afraid of being laid off have curtailed their spending. My lenders have stopped making new real estate loans and even renewing existing loans. And, both my Governor and Mayor have begun to lay off public employees because of the decline in



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their income, sales and property taxes.

While the stock market may be making new gains, up about 75% from its bottom from the same time a year ago, as far as real estate is concerned, we are still in a recession – no, a depression. Curiously, the stock market has grown even while most public companies have not been able to increase their revenues. How, I wondered, can this be? I finally figured out that stock prices have risen because earnings have risen, and the only reason that earnings have risen is that corporations have cut expenses faster than they have lost revenues. What is the largest expense that they have cut? Simple: people. So, while corporations have behaved perfectly rationally in the recession, their gains have come at real estate's expense: in short, it is all about jobs, and real estate cannot recover until the economy and those same corporations begin adding jobs again.

The Experience of the Last Cycle

I also began to recall the last real estate depression - in Texas it was in the late 1980's. During that time, I recall seeing a bumper sticker that said: "Oh Lord, let me have just one more real estate boom - I promise not to screw it up again this time." Well, our prayers were answered, and we had a boom, an incredibly strong and long boom. Values increased four to six times during this period (for instance, class B office buildings went from about \$30 psf to about \$150 psf). We went from 1991, the trough of the last cycle, to late 2008, when the real estate market finally crashed following the Lehman Brothers/AIG weekend in September 2008 and the credit markets froze.

The Current Real Estate Depression

So, we are in a significant real estate depression, and will be for a long time, since even the most optimistic economists do not expect job growth to increase significantly for a few years. We are in this predicament for two major reasons: first, the supply and demand for space is way out of balance

– we built too much space in the boom that went too long (over-supply) and then our tenants began to cut back on space (under-demand); and second, the credit markets have gone from feast to famine. Following the Lehman/AIG debacle, equity was immediately re-priced – that's why the stock market dropped (DJIA from 14,300 to about 6,300 from September 2008 to March 2009), and all lending evaporated as the banks collapsed, causing the TARP legislation soon after. It was the perfect storm.

Real estate has suffered in exactly the same way, with a series of hits: the first hit, a cap rate (or discount rate) jump both because of the re-pricing of real estate equity and the elimination of leverage. Owners of well leased buildings saw their values drop 25-40% simply because of the change in the cost of capital. Then leases began to weaken, as occupancies and rents began to fall because of the supply/demand imbalance, and values fell further. Then, in a full-circle punishment, cap rates rose again and values fell again, because of the increased risk from the weakening leases and resulting cash flows. Well leased commercial properties have lost 40% of their value, and partially occupied buildings, or those requiring improvements or other cash investments, much more. Non-cash-flowing assets like land are nearly totally illiquid – there are few if any buyers at all.

All of this caused me to reflect further on what had happened in the late 1980's, when the real estate markets fell in similar fashion (December 1986 was the peak, when oil prices fell in January 1987, and Washington changed the tax laws with "Treasury 1").

The Behavior of Real Estate Cycles

Most people think that cycles are symmetrical – that is, they behave similarly going down as they do going up. Wrong! At the peak (December 1986 then, September 2008 now), transactions cease altogether. Why? Because no one can sell into a declining market because no one will buy into a declining market. Why would anyone buy a major asset knowing that it would be worth less in the near future than it would be at the purchase? This is especially true if the asset's operating performance would also be declining – as was the case then and is the case now.

So, what really happens is the market falls off a cliff. We all become like Wile E. Coyote chasing the Roadrunner – we run off the cliff and do not realize nothing is under us until we look down, much later. Then, we fall too. The whole market goes into suspended animation and in reality, no one knows where it really is, since there are no transactions to measure it.

The market does not re-establish itself until at least three things happen: 1) leases and Net Operating Income start rising again, but this requires positive absorption from positive employment growth, from levels which have bottomed out after much further declines than we have experienced so far this cycle; 2) prices have to be adjusted downward far enough to offer investors sufficient and confident returns at these reduced leasing levels, including pricing well below "replacement cost" – a protection for the investor into the future; and 3) there has to be sufficient investment capital to finance the purchase of the property. In the last cycle, these elements were not in place for five years – from 1986 to 1991, and values had fallen by about two-thirds from their peak. Once the markets (the leasing market and the investment market) had hit bottom, they began to grow again. But, pre-fall values were not achieved until about five years after the trough, in 1996 or so – a total of ten years, peak to recovery.

So, if history is to repeat itself, which I expect that it will, if not precisely, then, say Class B office buildings in Houston will fall from their high of \$150 psf to about \$50-\$75 psf, depending upon their unique leases and other characteristics, and in the main, will not attract investors until about 2012 or 2013, another two or three years. Remember, there must be capital in place to finance these purchases as new investments, and while some equity capital is just beginning to trickle into the investment market now, it will be a long time before the market is strong enough to attract enough capital to finance all the buildings which need to be re-financed or purchased out of foreclosure. (Have you tried to get a loan lately? When do you think your bank will be back in the market?)

The Four Stages of A Workout

Now, what should you do if you are an owner of a building today? What should you do if you are a lender to an owner of a building today? What should you do if you are an investor trying to acquire a property today? The first answer for each position is to understand fully what I have explained in the prior paragraphs.

The second answer is to consider the four stages of a workout. They are identical to and taken from the four stages of grief: denial/disbelief, anger, depression, and finally, acceptance. Anyone who has lost a loved one can identify with the emotional – as well as the economic trauma – that a workout represents:

- Denial/disbelief – When the market peaks, borrowers begin to experience cash flow difficulty (declining leases, etc.), and try to support their projects with cash from other sources. Obviously, lenders encourage this support. Both sides generally and genuinely believe that the troubles will be short-lived – and the borrowers want to protect their equity and the lenders want to protect their loan. Neither side wants to concede Wile E. Coyote's position. But, the fall eventually comes.

- Anger – At some point, borrowers recognize that the markets fall is more than temporary, and will not return soon. They try to re-finance or sell, but there are no takers. Lenders at first are patient, but soon demand more information and support. Borrowers try to re-structure the loans, but the lenders refuse the overtures, and anger begins. Borrowers finally conclude that their equity is gone (if a property has more than 75% leverage and the market falls more than 25%, the equity is gone), and are unwilling and more likely, unable to support the property. The loan then goes into default and the anger increases. Unless pressured by its regulator, the lender is reluctant to foreclose and recognize the loss in value of the property and value of the loan. The lender's behavior at this point is called, "extend and pretend", and later, "delay and pray."

- Depression – At this point, some borrowers and lenders begin to recognize that getting mad does not help anything – it does not improve the prospects for recovery – especially if the market, rather than the borrower, is the culprit. So, depression results. I suggest that there are three definitions of depression: 1) the recognition of the depression of values (as noted previously); 2) further depression of the market, as foreclosure sales become comparables that appraisers use to document and measure the market – which previously had not been possible; and 3) the emotional depression that affects people as humans. (Imagine being a family who has lost their home to foreclosure, and you begin to feel how a borrower

of a commercial property feels at foreclosure as well.) Lending officers can lose their jobs and sometimes, their institutions fail.

- Acceptance/acquiescence - Finally, all parties get real, and sell to new investors, but at very low prices when all conditions above are satisfied. There is interesting behavior which dominates market decision-making during this phase: the bid-asked spread. At the beginning of the process, investors' bids are low, and owners' (really, the lenders') asked prices are high. As time goes on, bids rise a little (as market confidence returns slowly and more investors re-enter the market, again, slowly), but in time, asked prices fall, as lenders (now either foreclosed owners, or economically in control of the property) are less and less willing to hold on or face other pressures to sell. So, the bottom line is that asked prices eventually conform to bid prices, and sales occur. Generally, all original participants are gone by this time. Market pricing is re-set again, and the cycle begins anew.

What Should You Do Now?

So, what to do if you are an owner, a lender or a new investor? As an owner, recognize your position in the marketplace, and if/when the property can no longer service the loan(s), do not support the property longer than is necessary. As a lender, recognize that when the owners' equity is gone because of depressed market values, you are economically the owner and will eventually control the property and its eventual disposition to new investors. Behave prudently, but aggressively - as an owner should. As a new investor, be careful, too - do not enter too soon, do not overpay, make sure that the property's anticipated performance will more than adequately support its new capital structure and cost of capital. The real estate market will continue fall until economic recovery brings increased absorption of space. Many investors are looking at the market now, watching closely the few transactions which actually occur to determine their underwriting parameters and trying to assess when the time is right to enter - perhaps "on the next one." But, alas, it is difficult to determine a bottom, and no time is ever perfect. "It takes all kinds to make a market."

Can We Start the Recovery Earlier?

What could we in the real estate industry do to bring forward the market bottom? To hit bottom and begin the recovery sooner? Again, a history lesson is in order. After several years attempting to fix the Savings & Loan crisis, the FDIC and the RTC (the Resolution Trust Corporation) decided that three elements were need to solve it, although none of the three elements which worked successfully then are in place today - yet:

- Recognition - that real estate markets were actually impeding overall economic recovery, and the "suspended animation" must come to an end. William Seidman, Chairman of the FDIC and RTC decided that troubled assets must be transferred from their troubled lenders and the government itself to the private sector - new investors.

This is much different than the current "extend and pretend" and "delay and pray" position of most lenders and their Federal regulators today.

- Market clearing prices and auctions - Seidman and others concluded that no new investors would overpay for individual properties - that the sellers had to find market clearing prices, which could only be accomplished with open auctions without reserve prices. He also concluded that a few transactions here and there would not be adequate, that the inventory of properties had to come to market relatively quickly, because again, no

investors would purchase if they suspected there would be an overhang of other properties to come on the market later at lower prices and undercut their own transaction.

This condition, too, is not in place - the U.S. Treasury Department recently persuaded the Financial Accounting Standards Board to promulgate FASB 157 which changes the definition of value from "willing buyer and willing seller" to valuation based on what the seller expects. In other words, owners of property (or loans) can value their assets at whatever they want, until they sell. Thus, by continuing to hold the assets, they can overstate the value of their assets (and their capital position), until they eventually come to market. In reality, the extend and pretend is unstated national policy, because if all bank loans (and insurance company loans, etc.) were "marked to market" currently, the capital position of the financial services industry would be wiped out and would fail all over again, making the TARP rescue look like a picnic. So, for the indefinite future, the bid - asked spread will stay wide.

In addition, banking regulators at the Federal Reserve and the Treasury have re-structured the banking industry to allow it to generate significant earnings (and banker bonuses!) by lowering banks' cost of capital - the theory is to let banks earnings rebuild their capital position to be used later to offset the losses from the eventual sales of the distressed assets. They also implicitly hope or assume that the assets will regain some of their lost value as the economy and jobs position improves.

- Providing new liquidity - At the end of the last cyclical downturn, all previous real estate lenders had been devastated. The FDIC and RTC realized that new leverage would be needed to finance the very purchases that were required to carry out the market clearing transactions noted above - and they worked very hard to replace them - with new special lenders like GE Capital; they worked with Wall Street (who were then the good guys) to invent "Equity REITs" and "mortgage conduits" - thus, the CMBS business was born. In time, commercial banks re-entered the real estate lending business, initially for mature, cash flowing investment properties, and later, for new development.

There does not seem to be any initiative on the part of the Federal Government today to provide new liquidity into the real estate investment market - in fact, most lenders state that their regulators continue to tighten credit decisions. And, a provision of the TARP bail-out was to make previous investment banks into commercial banks, bringing them under the control of traditional bank lenders. Thus, there is little evidence of financial innovation today and for the foreseeable future. Meanwhile, most non-bank financial institutions are not likely candidates for significant new investment, since most of them were the very institutions which lost significant values in their real estate portfolios in the recent downturn.

Looking forward into the near future, it is difficult to see the where the new liquidity to going to come from in market-sized amounts. True, a few individual investors and a few foreign investors are now entering the market cautiously with a very small number of transactions, and there is some new evidence of institutional activity (new REIT and CMBS offerings), but these examples are small and tentative at this early juncture, focusing on only the very top-tier properties. (In crisis situations, there is always a "flight to quality.") Moreover, with the stock market increasing, it will likely

to continue to provide a better mix of short-term returns and confidence than real estate turn-around investment.

There has been much attention paid to what shape the overall economic recovery will take - an "L" (a long, flat bottom without a recovery), a "V" (a rapid bounce-back from the rapid fall we have experienced), a "W" (a recovery, like a V, but then with a second dip), or a "U" (a flat bottom, and then a recovery). My own view is that the overall economy is experiencing a long "U", with general recovery beginning as Peter Linneman said a year ago, and the real estate recovery following it, but several years later. The key indicator is when demand throughout the economy recovers sufficiently to encourage corporations to begin to re-hire workers and build employment levels again. This will begin the real estate recovery, since space will be absorbed again, and properties' operating performance will recover.

The Elements of Recovery Are Lining Up

If, as the real estate recovery occurs, the other elements are in place - low prices, and adequate capital - at the same time, the recovery will begin. If and when this coincidence of factors occurs, properties will begin to - once again - increase in value. And, shortly thereafter, when supply and demand for commercial property space is back in balance, the economy will begin to experience inflation, as the excess money supply begins to circulate, and the Federal Government must inflate its way out of the debt it has incurred since the bailout of 2008 and 2009.

In conclusion, there is no other place that I would rather be than a substantial owner of income producing real estate purchased below replacement cost in advance of an inflationary surge. "Investors, start your checkbooks."



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