Looking Over the Horizon
by
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Hilton San Diego Bayfront
March 3\textsuperscript{rd}, 2011
10:40 – 11:20 a.m.
Slides will be available at:

The Burnham-Moores Center for Real Estate
Summary Up Front: What do I believe?

• Housing and Commercial real estate prices will continue to see much dispersion based on quality. Averages and indices don’t tell us much, but average prices will remain flat for 2011 based on a mix of trophy and trouble.

• Future commercial real estate values will be dependent on a race between higher interest rates and increasing rents.

• In about 2 to 3 years we will see rent spikes for office, industrial and retail property, even earlier for multifamily property. San Diego is a little behind average on these trends but will follow the pattern like a reluctant child.

• The best time to buy high quality commercial real estate was 2008 and 2009. But there is 2 to 3 years of distress opportunities left for those who can reposition, recapitalize or simply wait it out.
What should you do, if you believe me?

• Tenants: Despite the accounting disclosure problems tenants should now enter into leases that are as long term as possible, 15 years with an option would not be crazy.

• Landlords: I would suggest leases no longer than 2 to 3 years, expiring before the ramp up in new supply.

• Brokers: I would try and match up tenants that are growing with investors that have empty building opportunities where they partner in a residual equity upside sharing deal and eliminate the lease up risk which is plaguing real estate pricing.

• Developers: With prices below construction costs only BTS’s make sense, or upgrading existing buildings to the LEED EBOM standards or the GSA’s standards.
Where are interest rates headed?

- Theory: LT Risk Free Gov’t Rates should =
  - Long term real growth rate, GR, plus the approximate
  - Expected Inflation Rate, I, so:

<table>
<thead>
<tr>
<th>LT Growth Rate in GDP</th>
<th>Inflation</th>
<th>Nominal Rate for 10 Yr Treasury Bonds</th>
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</thead>
<tbody>
<tr>
<td>2.5%</td>
<td>2.0%</td>
<td>4.5%</td>
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<tr>
<td>3.0%</td>
<td>2.0%</td>
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<td>3.5%</td>
<td>3.0%</td>
<td>6.5%</td>
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But QE2 could keep us well below these figures for 2011 until at least June when bond buying eases off.
Price Per Square Foot Top Ten Office Markets Show Bias for Occupied Property
Price PSF for Office Buildings At 90% Plus Occupancy Over Those at 70% or Less
Investment grade was up 8% in 2010 and up 19% for the highest end properties (NCREIF TBI by MIT).

General grade (mostly under $2 million) was down 11% in 2010 and flat in January of 2011.
We see huge price spreads by deal size
What about distress?

- Is it heading up or down?
Distressed Sales as a Percent of Total Sales in the 4th Quarter of 2010

By Property Type

Source: CoStar
Percent of Bank CRE Loans 90 days or more past due

Source: FDIC

- FDIC insured with Assets > $1 Billion
- FDIC Insured with Assets < $1 Billion

Q1 2008, Q2 2008, Q3 2008, Q4 2008, Q1 2009, Q2 2009, Q3 2009, Q4 2009, Q1 2010, Q2 2010, Q3 2010, Q4 2010
CRE Distressed Sales as % of Market Size For 2010

Distressed Sales as % of Total Sales

As of 10Q4

Source: CoStar Group, Inc.

*Size of Bubble = Distress Transaction Volume
• Key indicators
  – Who is buying?
  – Starts
  – Absorption
  – Vacancy rates
  – Asking Rents
Office 2010 Net Buying by Investor Type in Millions

Source: CoStar Group

Bought
Sold
Net Purchases

Private
Institutional
Private Equity
User
REIT/Public

-$15,000
-$10,000
-$5,000
$0
$5,000
$10,000
$15,000
Long Term Office Deliveries as % of Inventory

Source: CoStar Group
Corporate Profits lead employment which leads absorption

Source: Moody’s Analytics
US Net Absorption and Office Using Job Growth

Source: CoStar Group
Top Buyers of Class A by Sales Volume

1. Hines - $1,499 million
2. Brookfield Properties Management LLC - $995.1 million
3. Beacon Capital Partners, LLC - $968.5 million
4. The Irvine Company - $919.8 million
5. Tishman Speyer - $716.7 million
6. Principal Financial Group, Inc. - $617.5 million
7. Kilroy Realty Corporation - $580.6 million
8. Legacy Partners - $534.2 million
9. TIAA-CREF - $529.9 million
10. Jamison Services, Inc. - $525.9 million
11. TA Associates Realty - $385.2 million
12. AEW Capital Management, L.P. - $372 million
13. Wereldhave USA, Inc. - $371 million
14. Broadway Partners Fund Manager, LLC. - $349.3 million
15. Korean Teachers' Credit Union - $333 million
CA Industrial: Absorption, Deliveries and Vacancy

The chart shows the trends in net absorption, deliveries, and vacancy rates from 2007 Q4 to 2010 Q4. The net absorption metric indicates the difference between the amount of space that is occupied and the amount that is vacant. Deliveries represent new space that has been brought on to the market. Vacancy rate measures the proportion of vacant space relative to total space available. The chart illustrates fluctuations over time in these metrics, highlighting periods of growth and decline in industrial real estate activity.
CA Industrial Rental Rates: All Classes

The graph shows the trend of average rental rates (Triple Net) for different types of industrial rentals from Q4 2007 to Q4 2010. The types of rentals include Direct/Relit Rent, Sublet Rent, and Average Rent. The rates decrease over time, indicating a decrease in rental rates for all classes.
CA Retail: Absorption, Deliveries and Vacancy
Leasing in 2010 Has Been Dominated by Discounters

Did you ever think you’d see this?

Source: CoStar; PPR
Grocery Stores Are Now Competing with Big Boxes – in most markets

Inventory by Year Built (Millions of SF)

Inventory Per Capita

Sources: CoStar; PPR
US Retail Sales (Through Dec 2010)

Source: Commerce Department
Pent-Up Demand For Consumer Durables

What we held off buying during the recession.
What else is driving retail spending? Could it be “strategic default”? 
Homeownership Heading Down and Mortgage rates are heading up which is great for MF owners.
The Demand Remains Uneven: Vacancy Change Second Half 2010
2010 Change In Asking Rents on Apartments
Multifamily Permits Are Increasing But Still Very Low
Summary and Rational Strategies

Low Risk
1) Buy highly occupied properties and get low returns with low risk.
2) Develop or buy senior and health care housing facilities, medical office or student housing.

Moderate to High Risk
1) Time to buy hotels!
2) Buy distressed office real estate jointly with a major tenant and share in upside.
3) Buy distressed multifamily property from owners and lenders using short sales, especially if condo conversion down the road is possible. Note: Avoid HOAs like a plague.
4) Invest in Mez Equity to compliment the lower LTVs.
5) Upgrade properties for the GSA or others seeking Energy Star labeled property or LEED certified where demand is increasing.
6) Invest in data storage facilities or biotech after learning the nuances of tenant needs.
7) Start a business, some wild ideas include:
   For a fee electric plugs in parking areas.
   Customized manufacturing with 3 D printer design technology.