

## Capital Markets Overview

By Jack Fraker, Vice Chairman CB Richard Ellis, Dallas, Texas



**Jack Fraker**  
CB Richard Ellis  
Dallas, Texas

### Where Are We Today, and Where Are We Headed?

We are now in 4Q 2009 (two full years past the onset of the national credit crunch), and the availability of debt and equity capital for real estate investments is still way off the market peaks. Without the debt and equity capital, the volume of investment sales transactions is at a ten year low.

In addition to the scarce capital, the continued bid-ask spreads between buyers and sellers have contributed to limited asset sales. A primary driver of this bid-ask gap continues to be an overall perception of distress in the market. In reality, opportunities for deals with distressed sellers are minimal in the industrial sector, as the vast majority of owners are not "under water" compared to other property types like retail and office. While many buyers continue to wait on the sidelines for more blood in the water, defaults and foreclosures in the industrial sector continue to be mild thus far. This perception of distress continues to cause an inability to come together on pricing, and until that gap is closed, the number of transactions will remain limited.

Also, industrial real estate, like all property sectors, is now engulfed by the commercial real estate crisis with lenders on the sidelines and investors unable (or unwilling) to call large amounts of capital from institutional partners. The supply of new offerings has declined, but has not kept pace with the decline in demand, thus resulting in an oversupply of inventory. Alternative investment opportunities (AAA CMBS tranches trading in the mid-teens, distressed debt opportunities and REITs offering attractive dividends) have also caused decreased property values as investors pursue these investment alternatives.

Investors now require "compelling" reasons to purchase real estate (or even present a deal to committee) in the current "moving target" environment. It is not just stricter lending practices that have stalled investors and dramatically reduced sales activity; skepticism about the future path of the economy and the corresponding impact on tenant demand is also causing speculation among investors placing funds in today's environment.

It may take some time to recover from this economic downturn and debt pricing may not get back to 2006/2007 levels in the short-term. Additionally, there is approximately \$60 billion of CMBS debt maturing over the next two years which may result in forced sales, or will compete for debt capital to refinance. As a result, we do not feel pricing will improve much over the next couple of years as we move through the painful, de-leveraging process.

In the near term, CBRE and other industry observers do not predict decreasing cap rates until rent rolls absorb current market rental rates. Compounding this situation, underwriting standards have shifted dramatically to reflect the effects that investors expect the recession to have on fundamentals. Following are a few changes that could affect near term NOI and the 10-year cash flow:

- Market Rents** – much more conservative and have declined from the last cycle's peak
- Downtime** – increased from the standard 6 months
- Renewal probability** – depending on the tenant, has decreased from 75%
- Rental Rate Growth** – no near-term spikes and probably flat for the next two years as the perception is that the recession will continue to affect rental rates
- Vacancy** – general vacancy now appropriately takes into consideration some level of market vacancy
- Credit** – much more focus on tenant credit and aged receivables
- Ti's/Commissions/Capital Reserves** – have all moved up to reflect a more conservative underwriting environment

**Speculative Lease-Up of Vacancies** – Vacant space is given minimal credit relative to the pricing prevalent from 2005-2007

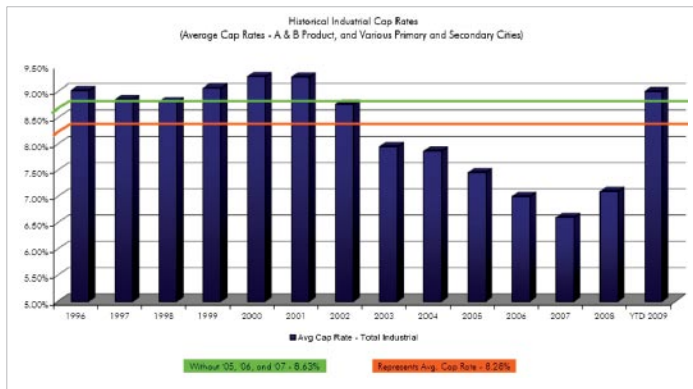
**Free Rent** – it's back in buyers' underwriting depending on the submarket dynamics

In addition to the shift in fundamentals, one of the more challenging aspects of trying to buy or sell properties today is the general lack of data points and sale comps given the limited sales activity.

When considering recent cap rates, there has definitely been a bifurcation of the property types, as core, Class A assets have an easier time finding buyers and, perhaps more importantly, finding lenders. Core industrial cap rates are strongest in the coastal markets and are reflective of the best-of-the-best assets with at least five years remaining on the lease term. Deals with vacancy, short lease terms, above standard tenant improvements, tenants with weak credit or exposure to retail-driven demand are particularly difficult at this time. The pricing gap between these type deals and core assets is at an all time high because of the flight to quality over the last six to eight months. That gap is beginning to narrow, as the market has had time to digest additional sale comparables, and buyers and sellers have confidence that the market pricing has stabilized (providing returns over historical averages).

### CRE Industrial Offerings Activity - Public Markets (January 2009 to Present)

Issuer	Completion Date	Amount Offered Including Over-allotments (\$000)
AMB Property Corporation	03/25/09	576,366
Kimco Realty Corporation	04/03/09	747,098
Inland American RE Trust, Inc.	04/06/09	3,166,575
ProLogis	04/08/09	1,153,680
Duke Realty Corporation	04/16/09	575,356
Weingarten Realty Investors	04/17/09	458,850
Inland Real Estate Corporation	05/12/09	111,376
Highwoods Properties, Inc.	05/27/09	150,822
DCT Industrial Trust Inc.	06/02/09	117,300
EastGroup Properties, Inc.	06/30/09	25,000
First Potomac Realty Trust	06/30/09	5,518
Liberty Property Trust	06/30/09	NA
PS Business Parks, Inc.	08/11/09	160,425
PS Business Parks, Inc.	08/14/09	17,825
First Industrial Realty Trust, Inc.	09/29/09	71,587
ProLogis	09/30/09	332,270



**ACTIVITY IS UP:** The worst is behind us, as consecutive months of increases in transaction volume have transpired. The boost has been primarily driven by the emergence of new buyers into the market. These active groups include Strong Balance Sheet Public REITs, Broker/Dealer Public REITs, Closed-End Commingled Funds, Hedge Funds, and Private Equity.

**HISTORICAL CAP RATES:** Existing acquisition opportunities present above average returns even removing the "go go" days of 2005, 2006 and 2007. It is important to note that yields began to decrease before 10-year, interest only CMBS debt was available. One could argue that acceptable yields in the CRE sector decreased through the validation of the asset class into the modern portfolio theory, as much as the excessive liquidity phase of 2004-2007.

**DATA POINTS:** Fear of catching a falling knife ground the market to a virtual halt over the last year, as a lack of sales comparables and points of reference kept many investors in a holding pattern. With the increased activity referenced above, CBRE is now able to produce multiple, relevant industrial sales comparables.

### What's Next?

Compelling opportunities are emerging in the nation's industrial market. While few transactions have closed in 2009, there is confidence that 2010 will lead to an increase in transaction volume. Transaction volumes, in select markets, will begin to recover in 2010 but investors will continue exiting secondary and tertiary markets for greater security and liquidity in core markets.

The top five markets of Dallas/Ft. Worth, Chicago, Atlanta, New York/New Jersey and Southern California will experience occupancy rate declines consistent with all the other markets but will rebound more strongly over the next five years. In the near-term forecast, rent declines may be slightly greater, given the breadth of the fallout in demand. When recovery begins, however, rents may have declined to such historically low levels that demand will increase, quickly turning positive in 2012. As such, rent growth for the hub markets should grow to healthy levels between 2013 and 2015.

While transaction volume has remained low, there are still reasons to be positive about the outlook going forward. Some highlights to consider are as follows:

**CASH IS WAITING:** There has been over \$23 billion (all property types) raised since 1/1/09 in the public markets which, when added to private funds, brings the total to over \$80 billion on the sidelines. The equity markets have begun to thaw and the 12 to 18 month pricing standoff will end soon in order to put this new equity to work while addressing legacy assets issues.

**DEFINE DISTRESS:** Relatively low loan-to-value thresholds have helped keep many industrial owners "afloat," as compared to other product sectors. The majority of lenders have thus far exhibited a desire to extend loans and work through issues with owners.

**NO NEW CONSTRUCTION:** The effects of weak fundamental performance will be mitigated by a virtual halt to new construction.

**BACK TO 10% TOTAL RETURNS:** Both unlevered IRRs are in the 10% range.

**LEADING INDICATORS ARE POSITIVE:** US factory orders have increased for the first time since November 2007, residential home values are increasing in many markets, stocks are performing better and oil prices are on the rise from their low levels of 2009.

While we are certainly in the midst of a difficult time within this real estate cycle, we are optimistic about the future of our national economy and our industry. While we don't expect the recovery to happen overnight, we are confident that the market will return to historical norms over the next 2-4 years.