

Welcome,

Following is the sixth in a series of newsletters designed to foster a healthy dialog. I hope you enjoy it and encourage your feedback and discussion. The full piece is also available on the web at:



<http://www.caswell.org/newsletters/20091208.asp>

Take a look on <http://www.caswell.org> for prior articles, access to resources and information on what I can do for you. If you know someone who would benefit from this piece, please forward it, or just let me know and I'll send it to them directly.

Please drop me a line and let me know your thoughts.

Regards,

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Who Controls Pricing?

The stock market is up, unemployment is down and shopping baskets are filling up for the holidays. We are experiencing signs of a tepid recovery as confidence slowly returns. With the prospect of a long, slow improvement in the economy, investors are looking for opportunities to profit. In this environment, it is critical to place your bets with a clear strategy. Leading indicators for different asset classes provide mixed signals, clouding decision-making. The movements of the stock market are fluid and somewhat unpredictable as it reacts instantly to news, statistics, and perception. It can be a gut wrenching experience for anyone with a vested interest in performance. Commercial real estate (CRE) however is much slower moving, with fewer visible indicators, and yet, it is far more predictable. In this edition we will explore the major forces that influence commercial real estate pricing, helping you make more informed investment decisions.

If you had a crystal ball that allowed you to predict the stock market, you could get rich quickly. The degree to which you could accumulate wealth would depend upon the accuracy and level of detail of your predictions. You could place bets as aggressively as possible, tempered by your faith in the reliability of the forecast. The problem with crystal balls in the stock market is that they only work for a short time. If your crystal ball provides longer-term trends, then the marketplace has time to observe your tactics and react, thus canceling out your strategy through adjustments in pricing. The stock markets are efficient and eliminate the creation of money machines. If you find a winning pattern, the market adjusts to cancel it.

To profit from a forecast you need an inefficient market.

Commercial real estate has patterns. These patterns are as timeless and never ending as the tide. Attempts to mute or change the patterns have consistently failed. Pricing bubbles reoccur several times per generation and yet investors are caught in them over and over again. To profit from these cycles, you need to understand them and have the confidence to commit. The relatively small pool of investors contributes to the inefficiency of CRE markets. The combination of predictive ability and inefficiency allows the educated CRE investor to consistently profit over the long term.

Is it time to get back in the water? With depressed pricing and so many distressed properties there are many emerging opportunity funds. Starting a successful fund requires careful preparation. Acquisition targeting strategies, diversification guidelines, and expected returns all require a careful blend of data, opinion, and above all, a detailed understanding of risk. The timing for raising investment capital is important. If you have the cash in hand too early, you risk making purchases prematurely, as values for commercial properties are still falling. It is difficult to raise additional capital when your initial fund returns are negative! At the same time, waiting for the market to clearly turn may be too late as the best opportunities for large positive returns come from buying at, or at least near, the bottom. Once the market has clearly turned, those low-price buying opportunities will dry up quickly. The time to buy into the market is in the next twelve months at the confluence of distress, cap rate decompression, income decline, and bank deleveraging. When any of these forces flatten or turn, price declines will slow. When two or three of these issues turn, prices will begin to rise.

What Is a Cap Rate?

The term cap rate is short for capitalization rate. Simply defined it is the income divided by the sale price. For a given income on a property, a higher sale price equates to a lower cap rate.

Think of a cap rate as similar to an interest rate on a savings account at your local bank. If you want to earn a return of 5 cents, and the interest rate is 5%, then you need to invest a dollar for one year. If, however, you invest at a rate of 3%, and you still want to earn 5 cents, the amount you need to invest increases.

$$\text{Cap Rate} = \frac{\text{Income}}{\text{Sale Price}}$$

A similar concept is yield. Specific definitions for yields and cap rates include specifications on what types of income, expense, and sale components are included.

What are the main influences of CRE pricing? The [March Newsletter](#) discussed a few of these including the impact of declining rent and occupancy rates. A study of historic commercial real estate pricing shows that cap rates have a greater impact on pricing than rents and occupancies [see sidebar "What's a cap rate"]. So what moves cap rates? It is commonly believed that cap rates vary with the ten-year U.S. Treasury Note. The relative ease of buying and selling U.S. Treasuries compared with that of real estate mean that real estate is required to offer a higher rate of return to the investor to compensate for the lack of liquidity. The difference between cap rates and Treasury yields can be referred to as the spread. Over time, the spread can expand or contract due to different factors. The largest effect on the spread is the volume of real estate sales transactions. In high transaction periods such as that from 2004 through 2007, investors were more able to find a buyer at a reasonable price in a short time, thus the premium investors required from real estate compared to Treasuries was reduced, and cap rate spreads were compressed. Current conditions make it very difficult for a property owner to sell quickly at a reasonable price, thus the risk premium for real estate is high, and the spread is large. Luckily for current owners, Treasury rates are now low, so even with the large spread, the cap rates are within historical boundaries.

The cap rate's multiplier effect on operating income means that a small change in cap rate has a large impact on pricing. Understanding what can move cap rates is important for anyone involved in real estate including organizations renting space.

Renters need to be aware of property sale pricing as it affects rents.

Owners who have paid high prices for a property expect to get good returns, and that means they expect higher rents. As the value of their property declines, they may be unwilling to give up on their hopes for a positive return and therefore push for higher than market rents. The smart tenant understands how far they can go in pushing for reductions in occupancy costs before they push the owner into failure. They should also understand what happens in a foreclosure process and the ramifications of a sale of the property.

If we accept that the primary influence on cap rate to Treasury spreads is transaction volume, then we can keep an eye on that volume to predict short-term pressure on cap rates. But how can we predict Treasuries? [PIMCO](#), the noted authority on such things has a long track record of positioning their clients well with fixed income investments including all sorts of bonds. Bonds yields and pricing are highly complex and often counter-intuitive. As the general economy improves, or is expected to improve, most of us understand that the stock market goes up. Bonds however, move to a different rhythm. Bond pricing is largely driven by the market's expectation for inflation. Those of us with some gray at the temples well remember the high inflation rates of the late 1980's with 15% mortgages and CD's of 10%.

What Are Treasuries?

There are different types of U.S. Treasury Securities. A quick reference can be found here: <http://www.treasurydirect.gov/indiv/products/products.htm> and is reproduced below:

Treasury Bills

[Treasury bills](#) are short-term government securities with maturities ranging from a few days to 52 weeks. Bills are sold at a discount from their face value.

Treasury Notes

[Treasury notes](#) are government securities that are issued with maturities of 2, 3, 5, 7, and 10 years and pay interest every six months.

<http://www.treas.gov/press/releases/hp375.htm>

Treasury Bonds

[Treasury bonds](#) pay interest every six months and mature in 30 years.

Treasury Inflation-Protected Securities (TIPS)

[TIPS](#) are marketable securities whose principal is adjusted by changes in the Consumer Price Index. TIPS pay interest every six months and are issued with maturities of 5, 10, and 20 years.

I Savings Bonds

[I Savings Bonds](#) are a low-risk savings product that earn interest while protecting you from inflation. Sold at face value. Check out our table that is a [comparison of TIPS and Series I Savings Bonds](#).

EE/E Savings Bonds

[EE/E Savings Bonds](#) are a secure savings product that pay interest based on current market rates for up to 30 years. Electronic EE Savings Bonds are sold at face value in TreasuryDirect. Paper EE Savings Bonds are sold at 1/2 face value.

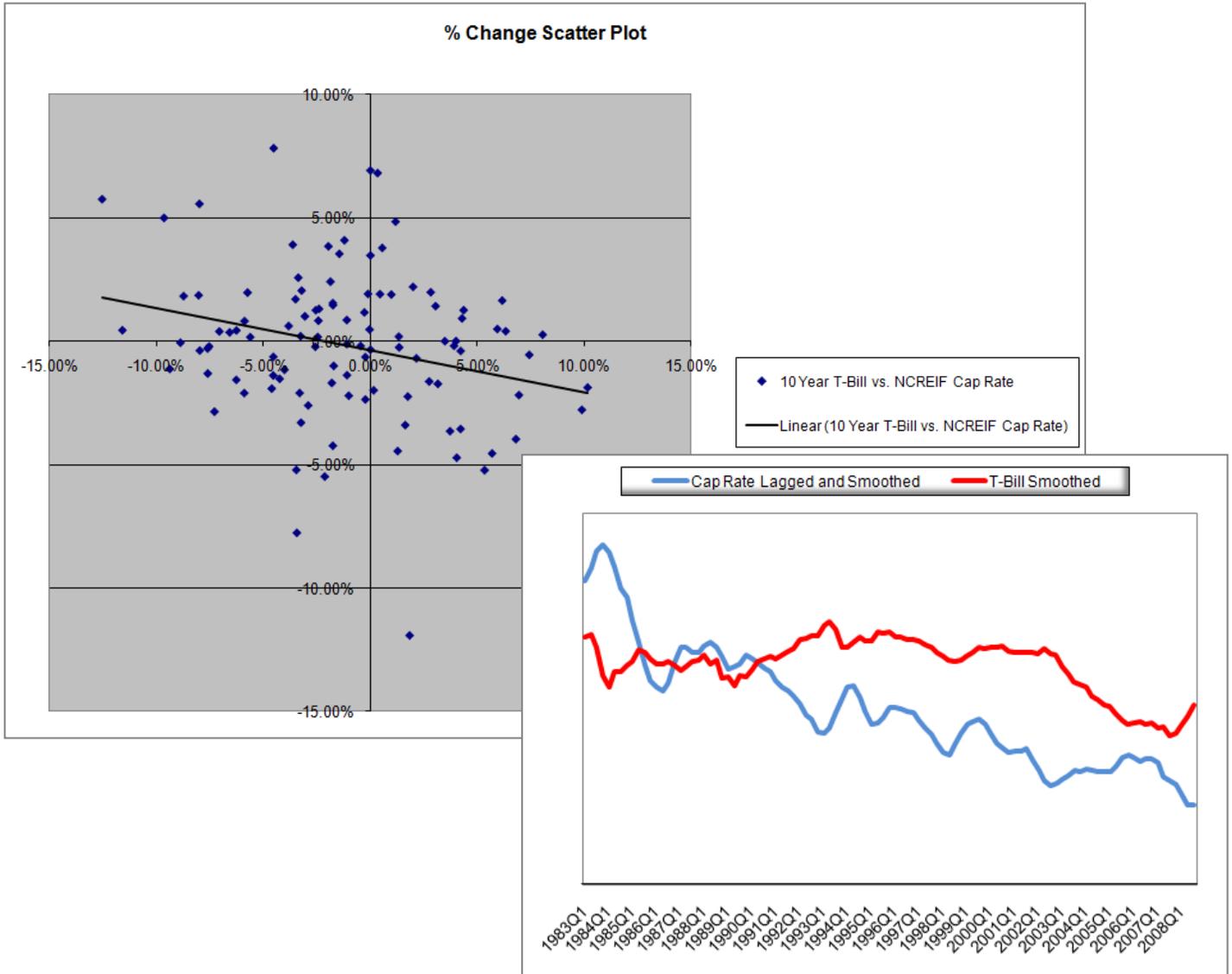
In the late 80's, people expected the dollar's purchasing power to decline. It is the expectations of bond purchasers that sets bond pricing.

So, we are back in the game of trying to understand the herd. But does the general public really influence bond pricing that directly? Certainly individual contributions to 401K's, IRA's, mutual funds, college funds, and stocks play a large role in setting share prices for equities. But does the average investor really have any influence on bond pricing? We all feel capable of expressing an opinion on the prospects for Wal-Mart, Apple, or General Motors, but do we think we understand the dynamics of changing inflation rates? Probably not, and as such, when individuals invest in bonds, they usually do so through bond fund managers and rarely change their allocations. So who DOES influence bond pricing? Well for one, the bond issuer. The U.S. Treasury Department periodically holds auctions for new bonds. The prices for those bonds are determined and institutions line up to bid and buy. One of the largest holders of Treasuries is the U.S. Federal Reserve. So in effect, the U.S. government prints money, borrows money, and holds debt on that borrowed money, with itself, through different departments. While it may seem strange, it allows the Fed to influence pricing of bonds, which in turn influences pricing on bank lending, real estate pricing, and all sorts of financial mechanisms.

During the current financial crisis, the Fed diversified its balance sheet. While it previously held most of its assets in Treasuries, it recently had only a third there with another third in mortgages and the final in other types of debt. So who else holds large amounts of Treasuries? China. As the Chinese economy has grown at a double digit pace, and the trade imbalance between the U.S. and China increased, China accumulated a massive amount of U.S. currency and Treasuries.

Let's back up a moment. Forecasts of pricing are needed to estimate the risks of investing. All forecasts are estimates based upon models using historical data and assumptions about relationships. A review of the relationships between CRE pricing shows that the largest

influence on pricing is the cap rate. Cap rates move more or less with other fixed income investment yields given investors are commonly seeking the greatest return at the lowest risk. The 10-year U.S. Treasury is an excellent index against which other fixed income investments are compared. The spread between cap rates and the 10-year Treasury moves with liquidity of real estate and availability of capital. Since both fluctuate considerably, the raw link between Treasuries and cap rates is poor, as shown in the graphs below:



Given the currently low transaction volume, the liquidity of CRE investments is poor, thereby increasing the risk and the spread between cap rates and Treasuries. Tight underwriting standards, low debt-to-value ratios, and the overall lack of available capital further contribute to a large spread.

Looking at the pressures on Treasuries, historically they have been expectations of future inflation, general economic health, and market forces of supply and demand on the debt of the U.S. Government. In addition, the Federal Reserve exerts its own pressure to spur or slow economic growth by setting pricing for short-term lending, thus applying pressure on the 10-year Treasury.

Currently the Fed has only a third of its assets in Treasuries, reducing its influence on Treasury pricing. From the two tables below, it is clear that the Fed holds fewer U.S. Treasuries than China, and only slightly more than Japan.

U.S. Federal Reserve Balance Sheet	
Term auction credit	101.0
Other loans (1)	84.8
U.S. Treasury securities (2)	
Holdings	776.5
Weekly changes	-
Federal agency debt securities (3)	
Holdings	155.0
Weekly changes	0.0
Mortgage-backed securities (4)	
Holdings	852.0
Weekly changes	0.5
Commercial paper held by	
Commercial Paper Funding Facility LLC (5)	10.5
Asset-backed securities held by	
TALF LLC (6)	0.0
Repurchase agreements (7)	0.0
Central bank liquidity swaps (8)	23.0
Reverse repurchase agreements (7)	57.6
Total:	2,060.9

Source: U.S. Federal Reserve, 12/2/9

<http://www.federalreserve.gov/releases/h41/current/h41.htm#h41tab2>

Foreign Holders of U.S. Treasury Securities	
China, Mainland	798.9
Japan	751.5
United Kingdom 2/	249.3
Oil Exporters 3/	185.3
Carib Bnkg Ctrs 4/	171.7
Brazil	144.9
Hong Kong	132.2
Russia	121.8
All Other	941.6
Grand Total	3497.3

Source: U.S. Treasury Dept.

Markets are not entirely transparent. While individual trades through exchanges are reported and can be tracked, the activities leading up to the placement of a trade order are not visible. It is not entirely possible for example, to know precisely who is watching whom. Because of this, we don't know who the real leaders are in

orchestrating plays to drive pricing up or down. That said, it is clear that some players have more control than others. [PIMCO](#) manages large bond portfolios for institutional investors and due to their scope and perceived expertise, wield tremendous power. With great power comes great responsibility, and in a well structured market, a lot of regulation and oversight. If PIMCO wants to continue to operate in the U.S., they need to continue to follow every regulation and behave as responsibly as possible. So in a way, their power is

heavily restrained, preventing them from exercising that power.

In contrast, the People's Republic of China does not face the same degree of obligation in opening themselves to scrutiny by U.S. financial regulators. China owns a lot of U.S. Treasuries. They have the power to move the market. They also have the freedom to exercise that power. Finally, the concentration of political power within China means that a small group of individuals have the ability to make decisions and execute on those decisions.

This combination of factors makes the Chinese Central Committee the largest single potential influence over U.S. bond, and therefore, commercial real estate pricing.

The important question then, is what does China intend to do? To answer this question, we can look at the past for similar situations where China has taken pricing control of certain commodities markets. Better still, we should explore the motivations of the Chinese Central Committee, from as close to their perspective as possible. Shed any cold war mentalities and prejudice, and look at what China has accomplished, and what it proposes to accomplish in the coming age.

Chinese culture is an eclectic mix of hundreds of legacy kingdoms and peoples, forced together over the millennia through hostile bordering enemies, famine, natural geographic boundaries, and a more or less common vision. Much of the population persists in medieval agrarian lifestyles lacking the benefits of

modern medicine, technology and communication. To elevate the population, the government has experimented with free-market economics, massive development projects, and the largest urbanization program in the history of the world. By most measures, they have been successful. China's GDP, growing at an annual rate of 10.5% from 1996 through 2006, has outpaced Europe, the U.S. and most other developed nations. The consistency of that growth was cause for skepticism, but increased reporting and transparency has quelled much, though not all of that skepticism. In any case, the perception is the effective reality. That success however, is also a great challenge. The Chinese population, some 1.3 billion people, has come to expect continued growth and improved levels of prosperity.

So far, that growth has come from a combination of increased internal consumption, and exports. The trade imbalance between China and the Western World has contributed to a tremendous redistribution of wealth. Every time we buy another load of goodies at Wal-Mart, China gets a little richer. Currently the U.S. has a GDP per head of \$43,730 compared to \$2,000 for China. Such a disparity in an increasingly connected world is dangerous. As China grows wealthier, it becomes a more stable global partner, albeit a more competitive partner, scrambling for access and control of the same natural resources. From the Chinese perspective, the U.S. is a very important source of income. But the U.S. is not the sole or even primary focus of the Chinese government.



Chairman Mao

China's main focus is on its people. The quid pro quo between government and the governed is that the government is allowed to retain power as long as it delivers on its promises. No amount of military force can long overcome a failure to deliver. It is this tension that we need to explore further. The promise made by the Chinese Central Committee is that it will continue to deliver the double-digit growth, and improvements that the population can truly enjoy. The urbanization program is central to that delivery as the requirements for a manufacturing based economy are optimized in a more urban structure. It is therefore imperative that the urbanization program continues.



A few years ago I visited a new city being built between Shanghai and its port. It was striking in the scale and detail of construction. Even though no one yet lived there, a beautiful park at the edge of a lake offered areas for strolling and picnicking, and even a sign prohibiting barbecues on the grass. Today that city houses over 100,000 people. So far, the construction has been financed without significant debt. In fact, foreign investment into China prohibits ownership of property. Instead, developers such as [ProLogis](#) and others are allowed to build on leased land, with many layers of restrictions and no small degree of corruption from local officials requiring dubious permits and licenses. Experienced practitioners

are able to navigate these restrictions, and the payback for investors has been solid. But the Chinese themselves, using the income from their ever-growing exports base, finances the majority of the building. As the global economy slows, demand for China's products wanes. China can not slow its development projects. The Chinese population will not accept a slowdown in growth due to outside influences. The population will continue to demand payment on the promise of growth, and push their government to the same solution other governments around the world have relied upon, namely, government backed debt. The Chinese government may be forced to raise capital by issuing bonds.

I suggest that while Chinese culture is far less enamored with debt than the west, they are not completely averse to the concept. So what would the issuance of Chinese government bonds do to the pricing of Treasuries, and therefore to commercial real estate? First of all, for the investment community to be willing to purchase the new, untested bonds, they would require higher rate of return than the U.S. backed bonds. So with U.S. 10-year Treasuries yields under 3.5%, the risk premium for the Chinese bonds would put them at say, 5%. For China, a 5% interest payment over ten years is an easy bet given their double-digit growth rate. To make the offer even more enticing, they may be willing to issue them at 6%. Then investors would be far more willing to buy a Chinese Treasury than a U.S. Treasury, forcing the U.S. to issue bonds with a rate of perhaps 4.5%. In this way, the Chinese issuers would be able to exert upward pressure on the pricing of U.S. bonds. If however, they wanted to depress the rates of U.S. treasuries, they could convert some of their holdings and purchase even more U.S. bonds. It is clear that they have the very real ability to put substantial pricing pressure in either direction. In fact, they have the ability, and perhaps the motivation, to control pricing of global financial markets in much the same way as they have taken control of commodities. The scale of the Chinese economy, and the centralized control over both supply and demand, puts China in the drivers seat.

This apparent threat is yet another consideration in forecasting commercial real estate (CRE) pricing. For the investor in CRE, it is still an enticing asset class, given the ability of CRE rental income to adjust to inflation better than most bonds. For a long term buy and hold strategy, we are entering a period of excellent opportunities for acquisitions. Recognize that while prices are likely to continue to decline for as long as five quarters more, a stabilizing employment picture means that income from rents is unlikely to decline longer than that. Once you have purchased a property, changes in cap rates do not affect the income the property generates. If you are willing to tolerate a loss in sale value, you can continue to generate a high rate of return through the income generation of the property.



Solid research and a firm understanding of the concepts will help you avoid costly mistakes. For the long-term investor, the time to buy is imminent. A recent report from [Real Capital Analytics](#) highlighted the spread between core and value-add properties in terms of pricing and cap rates. Value-add properties are a euphemism for underperforming properties that could benefit from upgrades in physical plant, management, or leasing effort. When well executed, these upgrades can result in higher returns. Poorly executed, you have dumped more money into a bad investment. Core properties provide consistent income and are still commanding premium prices. Clearly, the market for commercial real estate has already priced in the value of a reliable income. So while fluctuating cap rates, moving with large global forces will affect sales pricing, the fundamentals of rents and vacancies will still control the income on commercial real estate. For now at least, there is little likelihood of a profitable quick flip on a property. Real estate is once again, a long-term investment.

What Really Happened Here?

This newsletter is more than it appears. It is a mix of the following skills:

Research - Writing in an accurate, informative and compelling manner.

Marketing – Getting the message in front of the right people – You! Finding topics of interest, and gauging that interest to increase response.

I.T. – The distribution email was generated from a program I wrote that embeds unique links into each email while still sending it through Microsoft Outlook so I can find it in my Sent Items. The embedded links help me track when you viewed the email. If you continued to the web to view other articles, it tracked that too, linking it to the originating email. These databases, programs, emails, and web pages are all integrated around campaigns. I wrote each component using simple tools to avoid constraints and costs of third party tools as well as wasted time dealing with version upgrades.

Project Management – Getting it all done in a reasonable amount of time meant making choices around content, quality, timeliness, tool sets, speed, and more. Incorporating the efforts of proofreaders, editors, permissions from sources, and other demands on time requires strong project management experience.

Strategy – You are looking at it. I am an experienced professional with success in multiple disciplines. The best way to explain what I can do is to show you. In searching for work, I apply strategies to networking and self promotion. The point is not the content, but the approach. Wouldn't you want someone who puts this much thought and care into everything they do, working for you?

So how can I help you? I am available as a consultant. Let me help you take your business to the next level. Please call today to discuss your ideas.

Regards,



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