Welcome,

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

http://www.caswell.org/newsletters/20090317page1.asp

Please drop me a line and let me know your thoughts: ward@caswell.org

Regards,

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How Long Can You Hold Your Breath?

Commercial Real Estate income lags the larger economy. The lag has been seen with each prior recession and all evidence suggests a continuation of this trend. The challenge for participants is to quantify the impact of this recession on the depth and duration of price reductions. Lack of agreement between buyers and sellers on pricing has contributed to a sharp drop in transaction volume. To remove the log jam, the job of the Researcher is to explain the boundaries of likely scenarios. In this short piece, I describe the possible drop in pricing based upon plausible declines in occupancy and rental rates. These assumptions lead to a prediction of office property income reducing by 38% with the decline lasting into 2011. Combine this with an increase in the cap rate from 7% to 10% and

we are facing a value decline of nearly 60% by the end of 2010.

The table below breaks it down in a gross oversimplification.

Year	Occupancy	Vacancy	Rent	Income Index	Cap Rate	Value Index
Definition for 2007:	As Reported By NCREIF	100% Minus Occupancy	As Reported By CoStar	Occupancy Times Rent	As Reported By Real Capital Analytics	Income Divided By Cap Rate
2007	89.49%	10.51%	$ 25.80	$ 23.09	7%	$355.21
2010 Forecast	79.70%	20.30%	$ 18.06	$ 14.39	10%	$143.94
% Change	-11%		-30%	-38%		-59%

Sources: 2007 Cap Rate: Real Capital Analytics, 2007 Rent: CoStar Group, 2007 Occupancy: NCREIF

So what do you do if you are an owner, tenant, broker, lender, or other interested party? Where can you make money, or at least lose less money, considering this prediction? The answer varies by your current position and long term strategies. However, the key is to think long term. There are few, if any, low-moderate risk strategies which will be profitable in the short-term. Future editions of this newsletter will explore possible strategies for market participants. However, before I progress too far, let's explore the assumptions which lead to these predictions.

No one has perfect foresight. Still, forecasts are useful for determining an agreeable expectation for likely scenarios. This forecast is a simple one. It is predicated upon a few assumptions:

- The worst of the incidents causing damage to the economy are behind us
- The fallout from that damage has not concluded
- There will be no other major terror attack, weather catastrophes or government mismanagement

Certainly there will be more banking and other business failures. There is always weather. Terrorists will continue to attack. The government will make errors in the view of nearly everyone. But as long as these incidents are within the normal range of the nightly news and do not provoke a heightened state of panic, it is reasonable to conclude that the damage causes are behind us.

Let's say for example, that I am too pessimistic. That would infer that the job losses will cease earlier than I predict. This being March, and the numbers still showing large losses, I don't think I am wrong on that side. If however I am too optimistic and the job losses continue to increase past May, the situation is correspondingly worse than I have described. Since my prediction is already more dour than others I see published, I am quite happy to stay where I am.

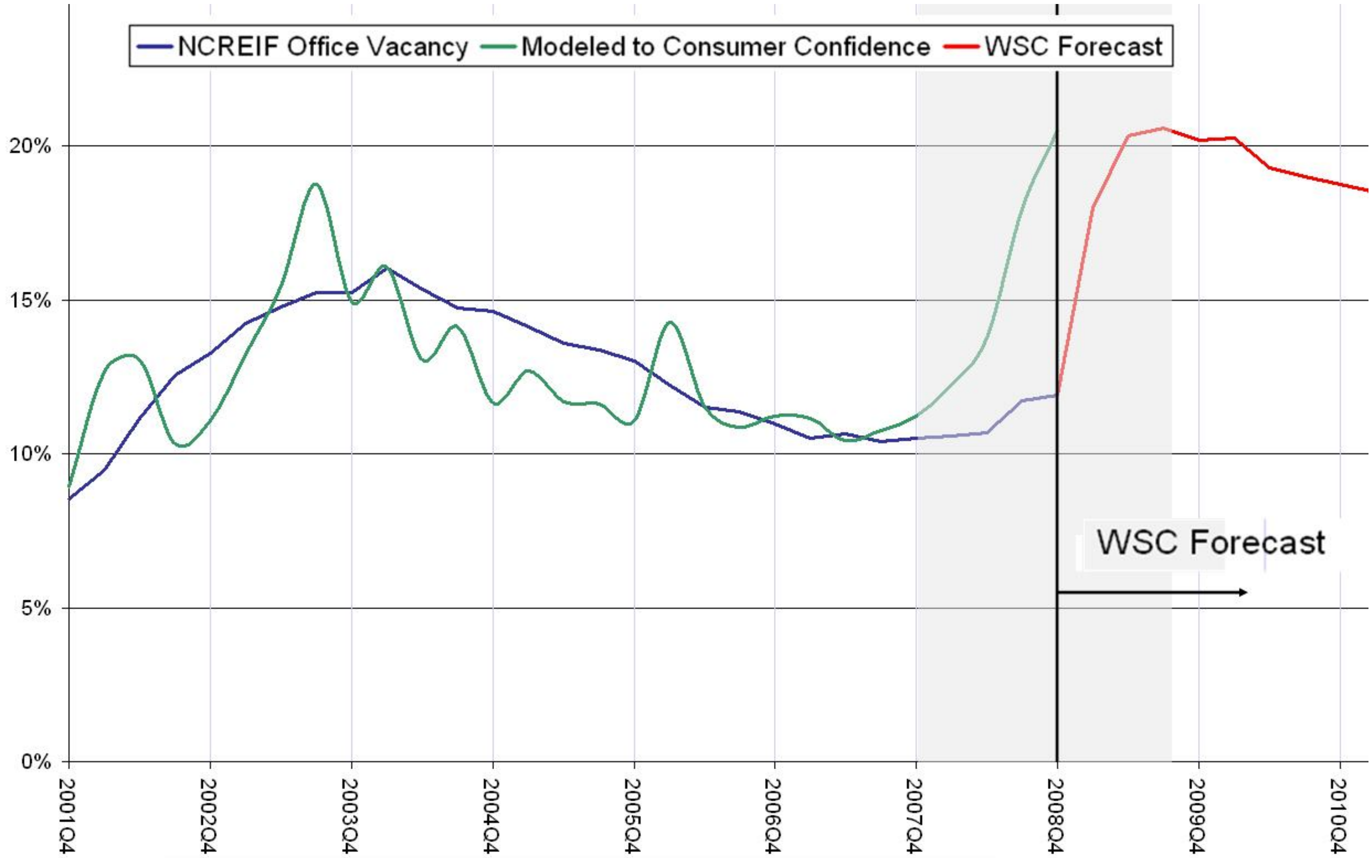
I would now like to skip the traditional recap of all events leading us to this point. We have all heard enough of the restatements of the facts. Instead, let's focus on determining the future. This forecast predicts a 10 percentage point increase in vacancy, based upon an historical analysis of the relation between Consumer Confidence and U.S. Office Vacancy.

Over the 25 year history of the NCREIF data, there is a very tight correlation with The Conference Board's Consumer Confidence. A simple regression using four quarter smoothing and a two quarter lag produces an R^2 of 92% and a 32% value when comparing the percentage changes. Simply put, there is a strong relationship between the two variables.

My forecast is flawed in its simplicity and forecasts a jump in vacancy of 6.1% by the first quarter of 2009. The structure of leases and dynamics of the office markets prevent that rapid an increase. What is useful about this model is its ability to quantify the pressures on Occupancy. Does it make sense though? Many argue that Consumer Confidence moves in a similar pattern as other predictive indicators and when used in a model creates a false degree of accuracy by simply parroting those other variables.[1] I have avoided this problem however, by using no other variables. I am not claiming that reductions in Consumer Confidence cause increases in office vacancies. However, like most forward looking indicators, factors which result in changes to Consumer Confidence appear also to result in subsequent changes to office vacancies.

[1] An excellent article on the viability of Consumer Confidence was published in May/June 1991 by Alan Garner in *The Economic Review* released by the Federal Reserve Bank of Kansas City.

OFFICE VACANCY RATE



Forecast using NCREIF Historic Office Vacancy Rates through 2008Q4 modeled against U.S. Consumer Confidence

Consumer Confidence is an excellent measurement of the mood of the American public. The importance of understanding the general population can be easily seen in examples such as the initial battle between the Mac and PC. The PC beat out a technically superior rival by catering to those features which the majority valued including price, availability of software, and compatibility. This pattern is the same in nearly every industry and field. If you can understand the mood of the herd, you have a better chance of winning.

So coming back to Commercial Real Estate (CRE), the herd is important here too. Certainly CRE decisions are not made by the common citizen. With assets often valued in the billions of dollars, development cycles lasting two to twenty years, and regulations requiring teams of talented lawyers and accountants, CRE is not a field for the inexperienced. And yet, the herd controls all. When reviewing the decisions made for investing, leasing, underwriting, or building in CRE, it all comes back to the income producing power of a property. That income power is beholden to its utility. That utility is ultimately judged by the herd. Build a mall where no one goes, or an office that no one wants to work in, or a hotel that no one will visit, and you are done. Own in an economy where once successful patterns change or stop altogether and face the same result. To win in the personal computer game, navigate to the front of the herd.

To win in CRE, accurately predict pricing and act on your predictions.

The commonly heard excuse for poor decisions is that "this property is different." It is true that a fundamental component of real property is that each is unique. No two properties occupy the same physical space, and are therefore truly different from every other property. Equally true is that some properties outperform others. But what is also true is that all properties are influenced by the same external forces. Those external forces are economic.

The economy is often measured in terms of GDP growth. GDP is made up of private consumption, investments, net exports, and government expenditures. Of these, roughly 70% is private consumption. Put another way, the herd controls the majority of the economic growth, or decline. The best measure for the attitude of the herd, and therefore its propensity to increase or decrease consumption, is consumer confidence. That would explain why consumer confidence is so closely linked to office vacancies. As consumer consumption increases, so do the payrolls. And of course, increasing payrolls means increasing employment which means increasing demand for office space. The same goes for declining demand. Declining consumer sentiment leads to declining demand for CRE. But how quickly, and for how long?

The answer to the timing is based upon some simple mechanics. This recession imparted upon everyone a perception of fear. The peak of that fear was between September and November of 2008. As the 2008 election reached its crisis and conclusion, attention to the media was at its height. According to Nielsen, Americans are spending a record amount of time watching TV and the political conventions, debate, and financial crises were key contributors to this trend in late 2008. CNN constantly showed the Dow Jones Index in a window, even through commercials. Mad Money's Cramer was featured on NBC's Today show urging everyone to sell their stocks. There was no escape from the hype that drove the panic. In that environment, no one, including senior managers, escaped the panic.

If you consider that employment decisions are ultimately controlled at the top of an organization, it is necessary for the senior executives to set the tone for expansion or contraction. It takes time for that mood to effect change in the workplace. First a message must be crafted. Next the message is communicated to the senior executives who are then responsible for disseminating that message and all that it implies to the VPs and line managers all the way through the organization to the administrators. Once the administrators get the message, they then work to make the decisions on cuts and adds. Those are reviewed by Human Resources, Accounting, IT, and everyone else who must be involved in major decisions. After a period of negotiation and wrangling, the decisions are made. Next come the notifications and job postings. Then there are the lags for termination effective dates on the way down, and interviews and starting dates on the way up. Both of these then take some time to reach government statistics. All together it is roughly six months from the time of a CEO's decision until the changes appear in the jobs reports. This means

the peak for layoffs will be between March and May 2009.

The rest of the analysis is easy. If job losses peak in mid 2009, then there is a 6 to 18 month lag for that to affect vacancies. On average, that puts the vacancy peak in mid 2010. We all know that vacancies affect rents. The magnitude and timing of that effect vary by property type, market, vacancy level, and other factors relating to demand, and the perception of future demand. Most agree that office demand will decline. What will be the perception in mid 2010? I will award a slightly used coffee mug for the person that predicts that correctly. Send in your votes now to ward@caswell.org, subject line "Demand perception forecast for mid 2010." While waiting for the results, I will assume that the precipitous drop in occupancy will have occurred and that unemployment will be above 10% and hopefully holding steady rather than still rising. Most importantly, average U.S. Office Vacancy will be above 20% for the first time in 25 years and likely higher than seen in the prior peak of 17.8% in 1985. In such an environment, rental rate declines will likely exceed the 20% drops seen in the last two recessions and a 30% decline may be a conservative forecast.

Rental rates lag vacancies. An article I wrote last year for Colliers' Knowledge Leader further discusses the variables used to track rents and the difficulties associated with them. Analysis of the trends, again oversimplified, shows a lag of another 6 to 18 months between rental rate changes and vacancies. This puts the bottom of rents at roughly one year after the bottom of occupancy.

Rental and occupancy rates will hit bottom in mid 2011.

With this long to wait, what should you do? Will the transaction markets remain in stasis until then? The answer to this question will have to wait for the next edition where I will explore the forces that control buyers and sellers. A quick preview:

Institutional investors are ruled by their own herd. As professionals holding fiduciary responsibilities, they are punished for straying too far from conventional wisdom. As Geoffrey Dohrmann, President and CEO of Institutional Real Estate, Inc. put it "If they take a chance and win, they get a bonus, if however they fail, they go to prison." In that environment, few would be willing to dramatically reduce pricing on assets now, and sell at 63 cents on the dollar. Instead, they will be forced to ride it all the way down, waiting until the wall of CBMS debt hits in 2010, and sell for much less. But there are always choices. Longer hold periods could prove the right course. As debt markets recover, those able to extend their positions, may find it worthwhile. In addition, derivatives and default swaps, which were just beginning to gain favor in U.S. CRE, may provide the much needed liquidity and flexibility. Still further,

Cash constrained owner/users yield excellent sale lease back opportunities.

With the dramatic shift in demand and pricing for CRE, the opportunities are equally greater than they were in the good old days of 2004 through mid 2007. But now, the risks are perceived more clearly as well…

Tune in next time for more in the ongoing story.

What Really Happened Here?

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

Research - Writing about CRE in an informative and compelling manner

Marketing – Getting the message in front of the right people – You!

IT – 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. When you continued to the web to view the article, it tracked that too, linking it to the originating email. These databases, programs, emails, and web pages are all integrated around campaigns.

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 experience in multiple disciplines. The best way to explain what I can do is to show you.

So how can I help you? I am available to work full time or as a consultant. Let me help you take your business to the next level.

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