Editor's Note

BY PETER C. BURLEY, CRE

"Winter lies too long in country towns;
hangs on until it is stale and shabby…"

–WILLA CATHER

THIS IS THE TIME OF YEAR that my "love-hate" relationship with Colorado leans heavily toward the latter. Where I live, in a remote valley at the foot of the Rockies, the ground is frozen and brown, lying fallow with scattered patches of the last snowstorm that remind us it won't be long until we will endure yet another frozen onslaught from the north. The trees lean leafless and lifeless against the winds, which blow here with bitter purpose.

The melancholy days are come, the saddest of the year,
Of wailing winds and naked woods and meadows brown and sere.
Heaped in the hollows of the grove, the autumn leaves lie dead;
They rustle to the eddying gust, and to the rabbit.

–WILLIAM CULLEN BRYANT

It is another four months, at least, until any measurable warmth manages to gain purchase at 7,000 feet. When it does, we will have a fleeting few moments of lush, green, warm, sweet summer, punctuated with magnificent pounding thunderstorms, herds of whitetail and elk, and countless birds of endless variety. Until then, we simply wait.

I've spent many hours focusing on the cover photo of this edition of *Real Estate Issues*. I've studied it. Not so much the lone figure on the bench as she reads the news (or is it the help wanted ads?). Instead, my attention turns mostly to the dog. Dogs are, for all of their faults, wonderful creatures. They find pleasure in just about anything at just about any time. Always ready to play, regardless of the season or the terrain. Forever inquisitive, they are in constant search of something to play *with*, sniffing, rooting, scratching at the ground or the snow, ever certain that the next game or toy is within easy reach. I think the dog in the picture wants to play. Surely, he is looking for a squirrel to chase. But, alas, all of the squirrels are hunkered down in their nests guarding their nuts. They will be out in due time, when it is safe and warm. For now, the squirrels are chicken, and the dog is out of luck.

In the real estate business, we have been like the squirrels, I think. Hunkered down, guarding our nuts. Waiting for a safer, warmer season to venture out; to dig holes in the warm ground, to plant new trees or to be chased by a friendly dog. Little wonder, really. It's hard to imagine a colder, more fearful time. Credit is effectively frozen. Occupancies shrinking. Revenues dwindling. Values skidding. Best to preserve our resources, lest the season tightens its grip. But, spring will arrive, as it always does, and I wonder: what will we have done with all those nuts? Are we going to eat them, plant them or just hoard them? Eat them and stay alive? Plant them and grow more trees? Hoard them and…and, what? Just *have* them?

In October 2008, this economic winter was rapidly approaching. That month, I attended an economic conference in Washington, the key topic of which was the rapidly developing financial crisis. Speaking at the conference were Fed Chair Ben Bernanke; FDIC Chair Sheila Bair; former Treasury Secretary Larry Summers, Princeton Professor Paul Krugman, and a host of other experts and policymakers. It was a serious conference about a serious situation. And the outlook was grim. Winter was swirling fast upon us. Lehman Brothers had failed and the financial markets were in danger of falling through the ice, pulling the entire economy with them. Looking back through my notes from those meetings, and recalling the discussions with Bernanke, Bair and others, I remain, today, convinced that TARP was absolutely necessary, as were subsequent bailout and stimulus efforts. Questions that remain at the end of 2009 are: how successful have those efforts been in thawing the credit markets or the economy? When will we see an end to this financial winter? Are there any signs of spring? What is going to happen to our business over the next few months, quarters or years?

At The Counselors of Real Estate Midyear Meetings in New York last April, *Moody's Economy.com* Chief Economist Mark Zandi gave us his perspective of the depth and breadth of the crisis and its impact on the property markets. He also offered some thoughts on what we might look for as signs that this recession was beginning to thaw and what recovery might look like in the months and years ahead. So far, he has been pretty close in his assessment and his outlook. Still, I thought it a suitable exercise to revisit recent trends and developments and to elicit Mark's current thinking and his outlook for the future. For several weeks this past fall, I hounded Mark by email for his assessment of conditions at year-end 2009 and his thoughts for 2010 and beyond. The resulting conversation, **"Real Estate Issues: Questions and Answers with Mark Zandi,"** offers some new insight that should help us understand where we are and where we may be headed in the months to come. My take: eat a few nuts, hoard a few but plant the rest.

Of course, it would be helpful to fully understand how we got into this mess in the first place. Two authors in this issue offer some guidance in that direction. First, in **"The Morphology of the Credit Crisis,"** CRE Hugh Kelly asks, "How could even a flawed product like some ... of the subprime residential mortgage loans have transmogrified into a debilitating epidemic affecting the entire credit market and the world economy?" Kelly argues that securitization helped to disguise the level of risk in debt portfolios, and that, while risk may be particular to each individual asset, what remains in a debt portfolio is "systematic risk... the risk that is common to all assets in the marketplace." Kelly guides us through the subprime mortgage crisis and shows us how systematic risk was severely mispriced in the marketplace, helped by a "flawed performance by the rating agencies." With an estimated $600 billion in subprime mortgage bonds outstanding at the end of 2007, subprime risk spread "widely across the world geography of investors." The repackaging of subprime debt into CDOs helped to fuel the fire, as did consumers who traded their own mortgages like commodities. Kelley concludes that "some of our choices could be much better informed were we to commit to a broader understanding of decision-making, good and bad," and that we pay dearly when we assume "that what goes up will continue to go up."

Certainly, as Kelly points out, a huge factor in the crisis was the reliance by investors on debt ratings of mortgage-backed securities issued by the credit rating agencies, the Nationally Recognized Statistical Rating Organizations (NRSROs). In his article, **"A Missed Assessment of Real Estate Debt Risk,"** CRE Marc Thompson (with analyst support from Ian Broff) points to those ratings and offers suggestions on assessing risk in debt securities and their underlying assets. Thompson finds some of the roots of the current crisis in the patterns of debt issuance and default during the past decade as "commercial banks became incrementally aggressive over time to maintain market share, as CMBS was growing as a formidable competitor in the market." As competition for market share grew, says Thompson, both credit rating agencies and "commercial bank regulators missed the assessment of real estate debt risk during this high debt growth period." Thompson proposes an Accumulated Aggregate Debt Loss Probability Rate methodology to assess risk on MBS issuances and other loan originations. Had the credit rating agencies explored the risks in aggregate debt and assessed that risk more accurately, Thompson contends, commercial banks likely would have been more conservative in their lending practices and limited the growth in debt, possibly averting the crisis in the first place.

Among the consequences of the recession has been a dramatic decline in new building, commercial or residential. Many homebuilders having suspended actual building operations are holding land assets as they await more favorable conditions. But, a number of publically traded companies are beginning to see opportunity. As Brian Curry, CRE, points out in **"Public Homebuilders Look to Build in 2010,"** builder confidence bottomed out in January 2009 at levels not seen in more than 25 years. But, a number of publicly traded homebuilders have since re-entered key markets with aggressive purchasing strategies, signifying growing optimism on the part of some builders going into 2010. Curry contends that with "limited new supply entering the market in the short term, builders who are able to acquire and control building lots in locations with limited supply have greater confidence in the ability to sell product." Uncertainty continues, of course, with respect to the chief demand generator of employment growth and the supply implications of still-rising foreclosures. And, as Curry points out, "further softening in home prices and demand could put aggressive pro formas with narrow return criteria at risk, and should the housing downturn continue unabated, those same builder/buyers may become sellers once again." Nevertheless, he suggests that "builders with rolling option lot take-downs will have the flexibility to react accordingly."

Economic recovery will surely be a tough slog, as Mark Zandi points out. And, the first signs of an economic spring will probably be evident in energy- and technology-based economic regions, including the Bay Area and Austin. In other areas, recovery will likely follow national trends. We were curious how the economy and property

markets were faring in the middle of the country, specifically in Chicago. So, we asked Bob Bach, CRE, of Grubb & Ellis and his colleague Simone Schuppan, to give us an update and an outlook from the Midwest. The **"View from the Middle"** gives us a rundown of the economy and the markets in the Greater Chicago area. "Market conditions are expected to soften further in 2010," Back and Schuppan tell us, "before embarking on a recovery beginning in 2011." Unlike the downturn of the early 1990s, they point out, the current "challenge" is not a matter of oversupply. Rather, it is a lack of demand. For the office market, Chicago has lost about 95,000 office-related jobs since late 2008, with only education, pharmaceuticals and government adding jobs in any measurable way. And, business uncertainty is likely to keep tenants from taking advantage of considerable available space, despite falling rental rates. Industrial markets have also seen falling lease rates, as much as five percent in 2009. That decline may slow as recent negative absorption of industrial space eases and, possibly, turns positive in late 2010. Retail vacancies have hit their highest levels in a decade, Back and Schuppan report, as new space continued to hit the market as the downturn began. Further, weakness in suburban housing markets have undermined performance among retailers in the suburbs, enabling retailers to shop for better, more upscale locations. In the more resilient apartment market, during the boom, "the focus was on high leverage and a well timed exit strategy because the profit was to be made when the property was flipped—the sooner the better." Now, investors focus on first-year cash yields, as lower loan-to-value ratios and tighter underwriting standards prevail. And, a now-old story: Chicago faces a glut of new apartment completions along with a substantial number of condominium projects hitting the for rent market.

Travails in the commercial real estate market, and the potential for yet another blow to the economy have led policymakers to address the issue of distressed properties and, specifically, the matter of loan workouts in the sector. While the prospect of additional write-downs could severely undermine bank balance sheets, new guidelines proposed by the Fed, the FDIC and the Comptroller of the Currency could backfire, according to Robert Pliska, CRE, in **"Going from Mark-to-Market to Mark-to-Make Believe."** Now, Pliska argues, federal regulators "seem to have decided to go along with the flow—to extend loans as long as they could…'extend and pretend' and 'delay and pray.' " The results, he suggests, could be a greater lack of transparency and consistency—just the opposite of what new regulations intend—and could undermine transactions in the future by actually constraining credit to otherwise sound borrowers.

For resource reviews in this issue, we begin with Scott Muldavin, CRE, and his look at CRE David Lynn's *Active Private Equity Strategy,* a "collection of market analyses, forecasts and strategy papers from ING Clarion's Research & Investment Strategy (RIS) group." Muldavin tells us that "Books on private equity real estate investment are rare, and even rarer is a book that spends less time defining terms and more time discussing the nuance and process of making private equity decisions. In this case, unlike in making sausage, the process is enjoyable to learn about." It is interesting, as Scott points, out that Lynn is willing to include a chapter on the subprime crisis, its fallout and impact on commercial real estate, a telling moment on the fallibility of our forecasts and of our ability to recognize the severity of events before they hit us. There is enough from what Muldavin tells me about just that chapter to make want to read the whole book.

"January, month of empty pockets! Let us endure this evil month…"

–Sidonie Gabrielle Colette

Another review comes from Julie McIntosh, CRE. McIntosh discusses George Friedman's *The Next 100 Years: A Forecast for the 21st Century*. One may think we have had it rough in the last few years. But, if Friedman is right, we have some fairly significant social, political and economic tension coming down the road. Think "China, Japan and the Pacific Basin; Eastern Europe—Russia and the former republics of the Soviet Union; Europe with its recurring tensions; the Islamic world; and Mexico." Critical labor shortages. Technology wars. Not necessarily pretty prospects. Definitely worth watching.

With this issue we welcome Mary Bujold, CRE, as associate editor. I look forward to another dynamic year as we continue to plan, improve and produce *Real Estate Issues.* I also thank (not nearly enough) Marc Louargand for his help and guidance as associate editor over the past year. And, thanks again to Carol Scherf, our managing editor, for her keen eye, her focus and her commitment to producing this premier journal.

I am waiting for hopeful signs of spring. Of emergent green shoots. Of life (and lifestyle) renewed. Of business better-than-usual. Of good times returned, or at least times better than we have endured these past two years.

All the Best,

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EDITOR IN CHIEF