2010 Commercial Real Estate Outlook:
Welcome to Weather Markets
by Ray Alcorn

For the past two years, economic stories resound with metaphors more often heard in weather reports than the financial press.

Maybe terms like "batten down the hatches," "keep your powder dry," "tsunami of debt," "frozen markets," and the over-used phrase "The Perfect Storm" are used to describe this downturn as such a surprise, an event outside anyone's imagination or control that terms normally used for natural disasters can capture our seeming powerlessness.

Similarly, with talk of recovery being on the horizon, we're bombarded with descriptions of "green shoots" in the economy, brought on by the funding of "shovel ready" projects designed to "prime the pump" of employment, increased consumer and business spending, and "stem the tide" of the foreclosure crisis. Are these economic updates or farm reports?

Cycles of Change
For me, the terms imply the cyclical nature of our world in general. Adverse patterns of weather and agriculture affect our comfort and quality of life, but we know they have been endured in the past and will eventually turn for the better.

Economic cycles are no different. This is the sixth recession of my working life, and the one thing the last five had in common was a 100% recovery rate. I have every reason to believe it will occur this time as well.

The question of course is: "When?" Politicians give their assurances that it's right around the corner. I don't think that's the right question.

My interest is in *"How?"* we will recover - as in: What policies (e.g. tax, regulatory, fiscal, and monetary) will be made available to stimulate growth; which industry sectors will grow faster than the broader economy; and the traits to look for in markets that will benefit from both.

If I know the answer to "How," then I can develop a strategy to profit whether the recovery is this year or sometime later.

An example: WL Ross was among a group of firms that recently agreed [Oct. 6, 2009] to buy $4.5 billion of Corus Bankshares, Inc.'s real estate. Starwood Capital Group, LLC and TPG led the group to buy the assets of the Chicago-based lender, which was seized by federal regulators Sept. 11 after its investments in construction loans for condominiums went bad.

Wilbur Ross, dubbed the "king of bankruptcy" and the head of WL Ross, stated to Bloomberg News, "Our methodology is to make a great big list: What's every thing we

can think of that's either wrong with the industry or that we just plain don't like about it?" "Then we start work on another list. If we had control of this industry, what would we do to fix each one of those problems?" he said. "Once we feel that there is a reasonable likelihood that the second chart kind of equals the first chart, that's when we get ready to do something." (Source: Bloomberg.com)

That's the type of thinking I'm talking about. Knowing how to profit is much more important than knowing when the recession is defined as "over." While Ross operates on a large scale, the thinking is the same when evaluating even small properties.

Commercial real estate is just now feeling the effects of the economic downturn. For the past several months talk has centered on commercial real estate loans being the next shoe to drop due to a wave of loan maturities that won't qualify for refinancing.

My ***2010 Forecast for Commercial Real Estate**** has lots of charts and figures detailing not only the coming shake-out in commercial mortgages, but also over $750 billion of residential Option ARM mortgage resets, an amount larger than the original sub-prime bomb that started this mess.

These twin threats will begin to rise in early 2010 and peak in late 2011. Just as this has been a long, drawn out recession, the recovery is going to be just as bumpy. And as the Ross example shows, those who understand the cyclical dynamics of recession and recovery, coupled with a return to fundamentals in valuation and deal structure, will profit handsomely from being in the right place, at the right time, with the right strategy.

The Negative Bubble

The benefit of a recession is to get inefficient capital and over-capacity out of the system. It's ugly and painful, but necessary to get to the next phase, which is recovery. In the process the market will overshoot to the downside just as it frothed over the top.

"Average" prices are just the middle of extremes, and in order for normalcy to return, there must be overly depressed pricing roughly in proportion to the prior excess.

This is known as "reversion to the mean," and the period of depressed pricing creates a "negative bubble" in asset prices. Professor David Geltner, writing for Moody's RealIndices website, defines the term:

"By the term **'negative bubble,'** I mean prices depressed 'unnecessarily low' in the sense that they would present 'super-normal' ex ante risk premia for buyers, greater expected returns than warranted by the amount of risk in the assets."

This happens in every recession and *especially* with real estate values. It happened in 1981-82, again in 1991-92, and most recently in 2001. But it doesn't last long. My projection is that the window of opportunity will be open for the next 9-12 months.

Do You Want In?
As the market clears the excesses, profits will be made by applying the fundamental principles of valuation for income-producing real estate as opposed to the anomaly of the past few years when the "greater fool theory" was the chief valuation criteria.

To be sure, there are significant differences in the cause of distress between then and now. But the cycle is the same. Then as now, when the markets are in such a state of confusion that "distressed" assets define the risk curve, pulling the valuations of healthy properties down with them, the discount in price becomes higher than the actual risk of the asset. The **opportunity** to create **value** comes to those who can provide ***solutions*** to the problems.

Prevailing deal structures will include cash flow mortgages, leverage of talent rather than assets, with capital provided by sellers, private financing, and yield-starved equity partners. Success will depend on the investor devising a feasible investment plan to capture and monetize the value opportunity.

Typically, recovery is uneven in location as well as industry sectors. The ability to identify markets with stable populations and a concentration of employers positioned to grow in the new economy is a key factor in choosing the right deals.

These are the basic principles of evaluating commercial real estate that many ignored during the bubble years. ***If you are asking yourself "Is this the time to invest in commercial real estate?" the answer is yes, but only if you take the time to learn these basic tenets.***

Many of the distressed properties I see are owned by investors who have never seen a downturn. They have no idea of how to cope. Those who understand proper valuation techniques and creative capital structures to create wealth are going to have a field day cleaning up the mess, not to mention being well-compensated for their effort.

**Ray Alcorn's recently released 2010 Commercial Real Estate Forecast is available at http://www.creonline.com/Ray-Alcorn/report-order-now.html and is included with the brand-new two-hour DVD presentation and workbook Getting Started in Commercial Real Estate that explains the fundamentals of analysis and deal structure for commercial properties.* *Reprinted with permission of CRE Online.*