THE LINNEMAN LETTER

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Volume 11 Issue 1

Commercial Real Estate Pricing Update

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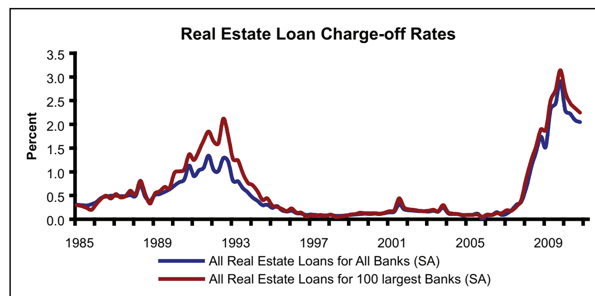
Our view of the pricing of stabilized assets today is that cash flows will rise by approximately 20% over the next 3-5 years, thereafter rising at approximately the rate of inflation. Add to this the fact that the leasehold claim for a diverse portfolio of real estate carries approximately the same risk as the debt claim on a diverse set of companies, as these companies (including government) are both the tenants and the borrowers. This implies that BBB (typical U.S. tenant credit) bond yields should approximate the expected total return from a diverse pool of commercial real estate. Historically, the yield on BBB bonds is approximately 200 bps above long-term Treasury yields, suggesting that the unlevered total expected return for a diverse portfolio of real estate is approximately 200 bps above long-term Treasury yields. The difference between the return on a BBB bond and real estate is that real estate has an appreciation component and a current pay component, while bonds only have a current pay. As a result, the cash flow yield on real estate over the long term should be below the BBB bond yield by approximately the expected rate of cash-flow growth. Since the expected rate of appreciation over the next 3-5 years exceeds the expected rate of economy-wide inflation, this discount today should be a bit deeper than normal. As a result, the cash-flow yield on commercial real estate should be 250-350 bps below BBB bond yields. At the moment, they are 90 bps below BBB bond yields.

It is important to distinguish between cash flow yields and NOI cap rates, as NOI cap rates must be adjusted for ongoing capital expenditures, leasing commissions, and tenant improvements (TI). This suggests that on a diversified basis, the dividend yield for a diverse portfolio of real estate should be approximately equal to the long-term Treasury yield.

Real estate loan charge-off and delinquency rates continued to fall in the fourth quarter of 2010. Charge-off rates for all real estate loans by all banks and at the largest 100 banks peaked in the fourth quarter of 2009 at 2.9% and 3.1%, respectively, but stood at 2.0% and 2.2% in the latest quarter. Residential and commercial delinquencies both peaked in the second quarter of 2010, at 11.4% and 8.8%, respectively. Fourth-quarter delinquency rates were 10.6% and 7.8%, respectively, both representing the second consecutive quarter of declines.

What a difference a year makes. In 2010, real estate transactions picked up dramatically, compared to 2009. According to Real Capital Analytics,



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U.S. Sales Transaction Activity

	Office			Industrial			Multifamily			Retail			Hotel		
	2009	2010	Change	2009	2010	Change	2009	2010	Change	2009	2010	Change	2009	2010	Change
# Properties Sold	637	1,201	88.5%	751	1,319	75.6%	1,023	1,553	51.8%	1,230	1,208	-1.8%	161	1,010	527.3%
Total Price ($ billions)	$16.0	$41.1	156.6%	$8.2	$16.9	105.4%	$14.8	$31.6	113.5%	$13.1	$19.8	51.5%	$2.5	$13.2	426.2%
Total Units*	88.5	202.1	128.2%	142	303	113.1%	184,613	310,346	68.1%	80	123	53.2%	27,630	139,089	403.4%
Avg PSF/PPU	$185	$211	14.1%	$60	$60	0.6%	$85,076	$110,371	29.7%	$145	$154	6.2%	$97,610	$158,570	62.5%
Avg Cap Rate	8.3%	7.5%	-80 bps	8.5%	8.3%	-16 bps	7.0%	6.7%	-31 bps	7.9%	7.8%	-3 bps	9.1%	6.6%	-250 bps

Source: Real Capital Analytics, Linneman Associates

Units = millions of square feet for office, industrial, & retail; apartment units for multifamily; rooms for hotel.

the number of office properties sold in 2010 increased by 88.5% over 2009 to 1,201 transactions. Similarly, industrial and multifamily sales transaction activity jumped 75.6% and 51.8%, respectively, year-over-year, while the hotel sector skyrocketed to more than 5 times the sales volume from the previous year. Only the retail sector saw a decline of 1.8% in transaction volume.

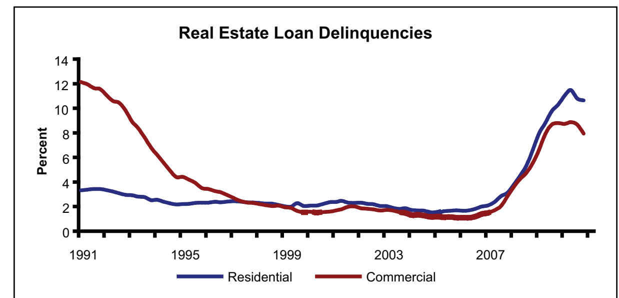
On a dollar-volume basis, total transaction activity in 2010 versus 2009 increased more than fourfold in the hotel sector, nearly three-fold in the office sector, and more than doubled for the multifamily and industrial sectors. The retail segment increased dollar-volume sales activity by over 50% in 2010.

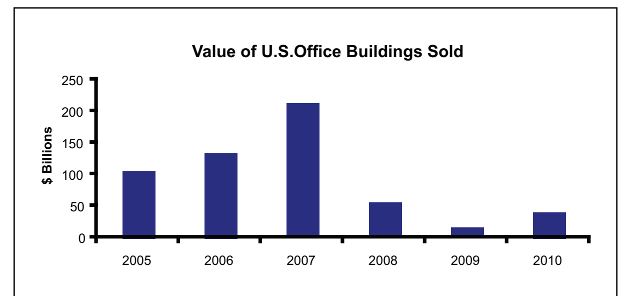
Average unit prices increased across the board for all 5 sectors in 2010, as compared to 2009 sale prices. Hotel sale prices grew by 62.5%, while industrial pricing edged up by only 0.6% in 2010. It follows that cap rates declined for all sectors in 2010: office (-80 bps), industrial (-16 bps), multifamily (-31 bps), retail (-3 bps), and hotel (-250 bps).

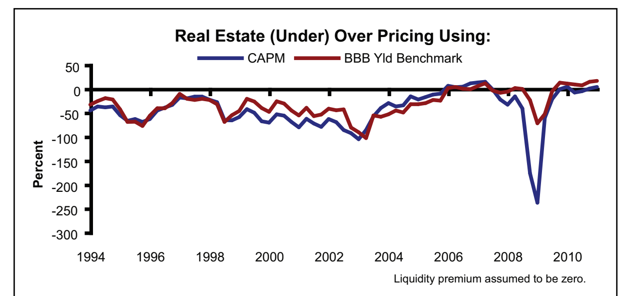
As we predicted in April 2009, the bottoming of private pricing (peaking of cap rates) occurred about 15 months after REIT pricing bottomed in March 2009. This pricing is consistent with the historic patterns of a 12-18-month lag in private pricing. Since peaking in the first quarter of 2009, total REIT implied cap rates have fallen by approximately 270 bps, from 9.2% to 6.5%, representing an FFO multiple increase from 10.9x to 15.4x through mid-March 2011. In fact, our analysis suggests that as of March 18, 2011, REITs were approximately 16% over-valued relative to BBB bonds, and 4% over-valued based on the Capital Asset Pricing Model.

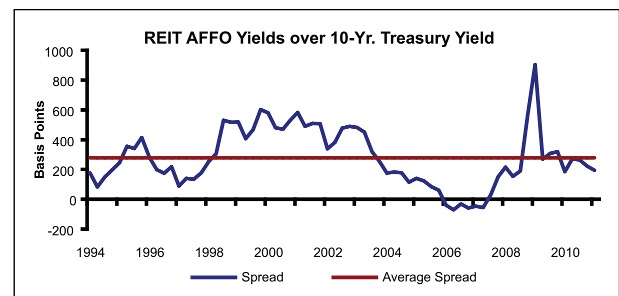
As pricing has improved, more owners (including financial owners of foreclosed assets) believe that prices have peaked and that future growth will be substantially below what is being priced into the market. Only time will tell who is right, but as bullish bidders have appeared, it is not surprising that sales have recovered.

Multifamily vacancy rates have fallen to 9.4% according to the Census Bureau. This 120-bp decline in multifamily vacancy rates reflects the near-complete stoppage of multifamily construction. Over the past year, only 148,200 multifamily units (5+ units) have been completed, while approximately 167,000 units have been destroyed.









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That is, the multifamily stock has declined slightly over the past year, even as household formation continues. We estimate that there are currently approximately 441,000 excess rental units, down from a peak of over 1.1 million units in the third quarter of 2009. This 700,000-unit decline has been a driver of improving multifamily rate and occupancy conditions around the country.

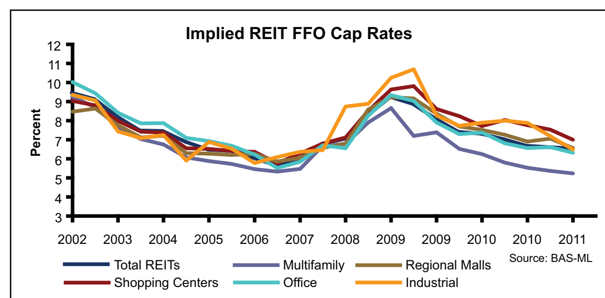
Effective apartment rental growth has been positive for the last three quarters, running an increase of approximately 70 bps quarter-over-quarter. This has primarily been achieved through reduced concessions.

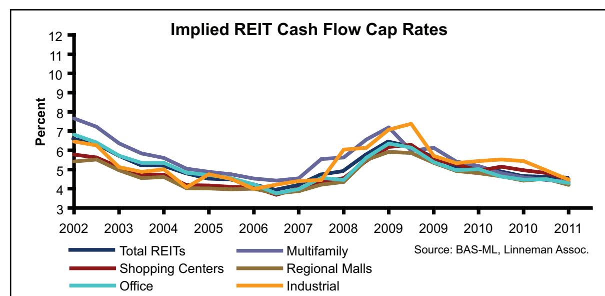
The improvements in the multifamily market are reflected in lower cap rates, running approximately 6.5% on average and sub-5% in the darling markets. This sector should continue to see robust income growth due to no net supply increase and increasing household creation, particularly as the 2.2 million pent-up households form in the presence of job growth over the next few years.

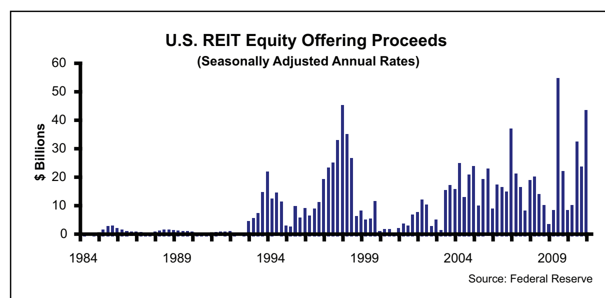
Turning to single family housing, production remains muted at a mere 496,800 units completed, versus an estimated 333,000 units destroyed in 2010. As a result, the single family housing stock has changed by approximately 163,800 units over the past year, while household formations have been about 420,000. The result is that homebuilder inventories are at an all-time low of 190,000 units. This is 158,000 units below the historic norm.

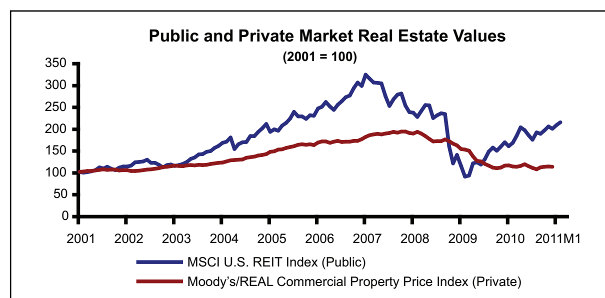
We estimate that the total number of excess single family units is approximately 772,000, down from a high of nearly 1 million units in the first quarter 2008. It is interesting to note that through the second quarter of 2005, there was a rough balance relative to historic norms. However, the imbalance grew steadily, reaching an excess vacancy rate of 1.3% of all relevant units.

The dynamics of this explosion reveal that while excess inventories of homebuilders rose to a maximum of 218,000 units in the second quarter of 2006, the excess inventory held by amateurs (flippers and speculators) reached a high of 945,000 by the fourth quarter of 2008. As we have previously noted, this amateur sector was historically a tiny sectoral footnote, which became the main holder of for-sale housing inventory overnight, when the Fed flooded the market with liquidity via prolonged low interest rates, and mortgage lenders decided that anyone who could sign a mortgage deserved a loan. Stated differently, while homebuilders got ahead of themselves, this was dwarfed by the speculative excess among amateurs. The value of homebuilders' excess inventory stood at approximately $50-$60 billion at its peak, while speculators held an excess i nventory of $250-300 billion. This $250-300 billion amateur excess has converted into a lender loss of close to $150-175 billion. It is the eye of the housing bubble storm.









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The good news is that homebuilder inventories now stand well below historical norms and must ultimately rise. Meanwhile, approximately half of the amateur excess inventory has been absorbed over the past 2.5 years. This amateur inventory has been slow to adjust because it involved the foreclosure of speculators and the subsequent grinding of units through the foreclosure and resale process. This process has been further slowed by uncertain regulatory policy, as well as needless damage many flippers did to their units before surrendering them to foreclosure.

This sector will continue to improve as jobs are added and the millions of pent-up households form over the next few years. However, until a robust and sustained job recovery is underway, homebuilders will keep their inventories below historic norms.