

Recession 2.0 and the Response of Institutional Investors

UC Roundtable
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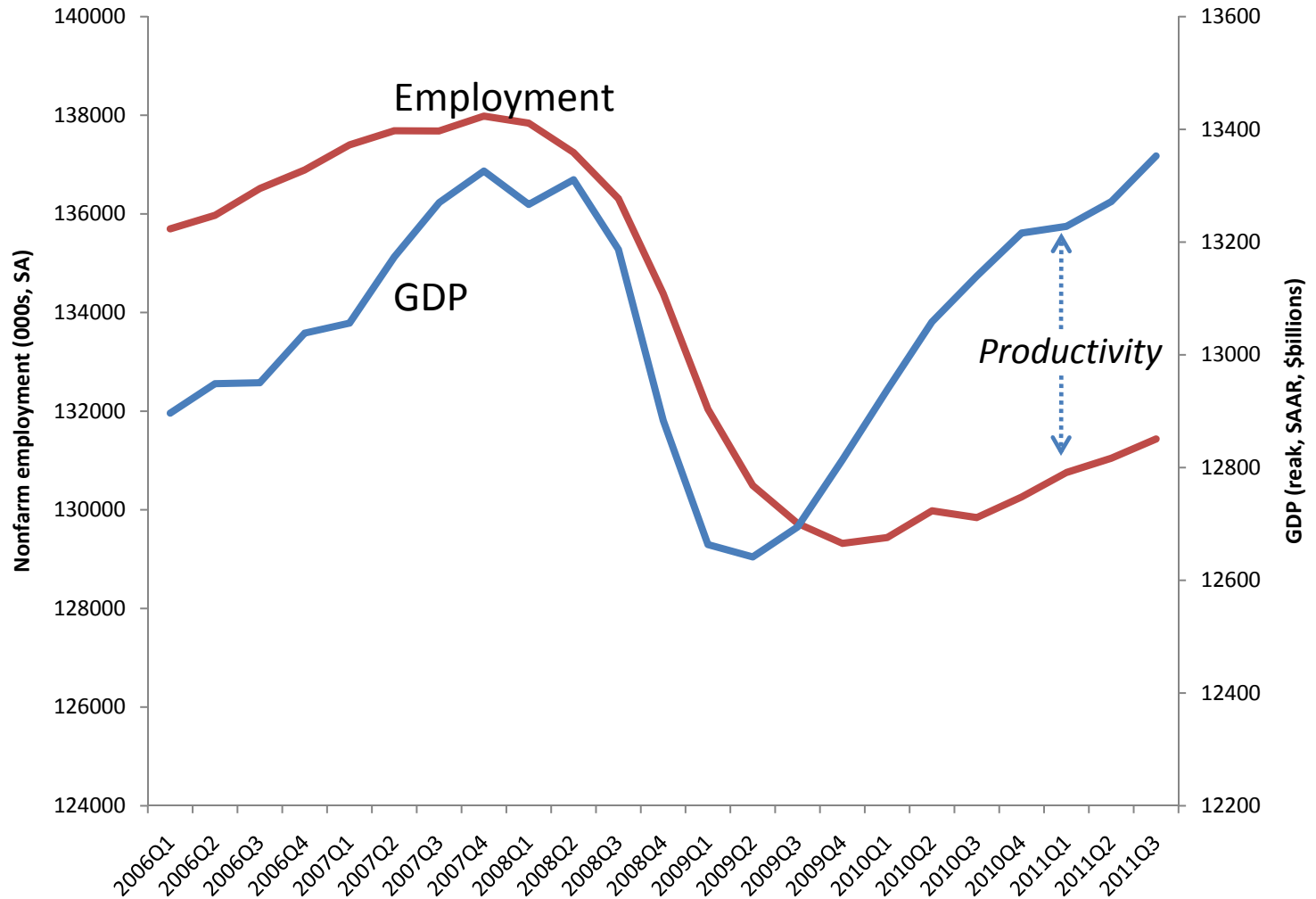


Recession 2.0? What Happened to 1.0?

- GDP back above peak

- lost 8.5 million jobs, peak to trough

- have regained just over 2 million jobs



Sources: Bureau of Economic Analysis, Bureau of Labor Statistics

Jobs key to recovery (including for commercial real estate)

- Construction jobs account for big loss.
- But definitely not all...



Office jobs

- 2.5 million private sector jobs lost peak to trough in “office prone” industries
- have regained 743,000

State and local gov't:

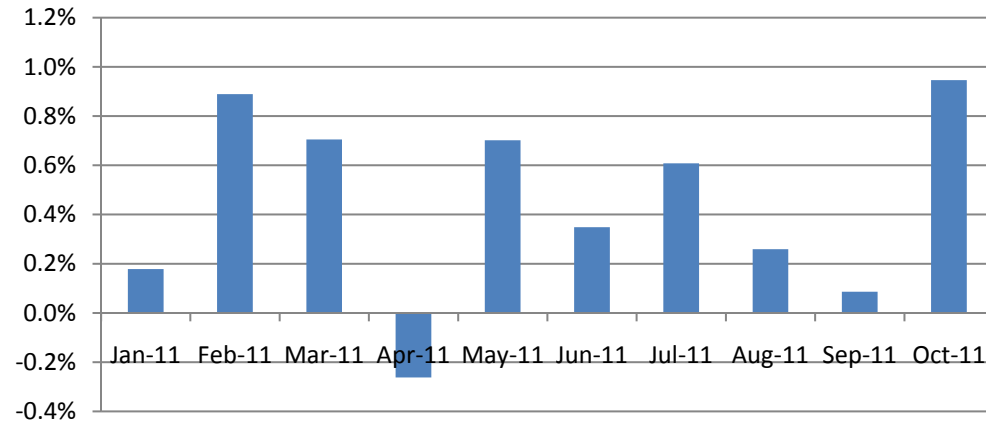
- 1955 to 2007, added 24,000 jobs per month on average
- Since bottom of jobs market, have eliminated 481,000 jobs (22,000/ month)

Some good recent signs?

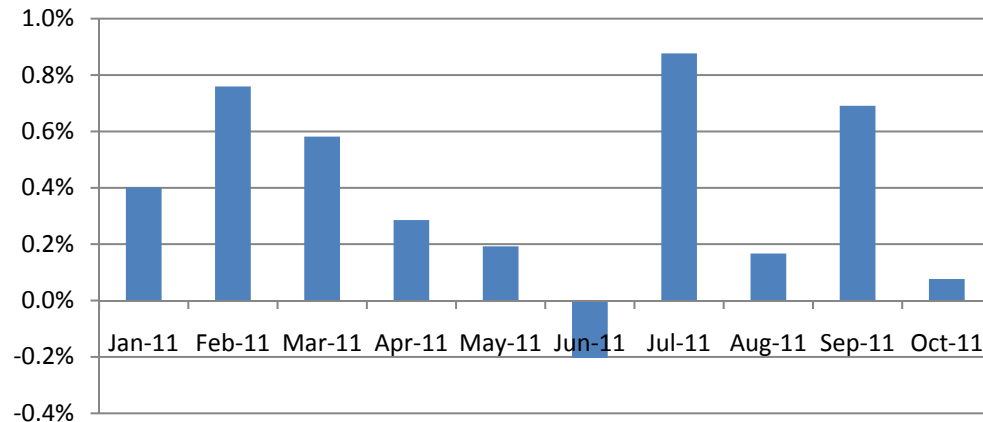
- economic leading indicator improving in October
- But, has been volatile, will it continue?

- Consumer spending continues to grow
- But, comes with decreased savings rate

**Composite Leading Indicator,
% change month/month**



**Consumer Spending,
% change month/month**



Political risk dominates



- budget debacle
 - credit downgrade, maybe another?
 - future taxes, spending uncertain
 - budget sustainability?
- Can US politicians get their act together?**



- euro crisis
 - sovereign defaults?
 - contagion through banking system
 - will euro survive?
- Can European politicians get their act together?**

Flight to safety continues in capital markets

- uncertainty created with each new crisis
- investors look for safe havens
- move into US Treasuries
- Treasury yields decrease
- current sub 2% yields

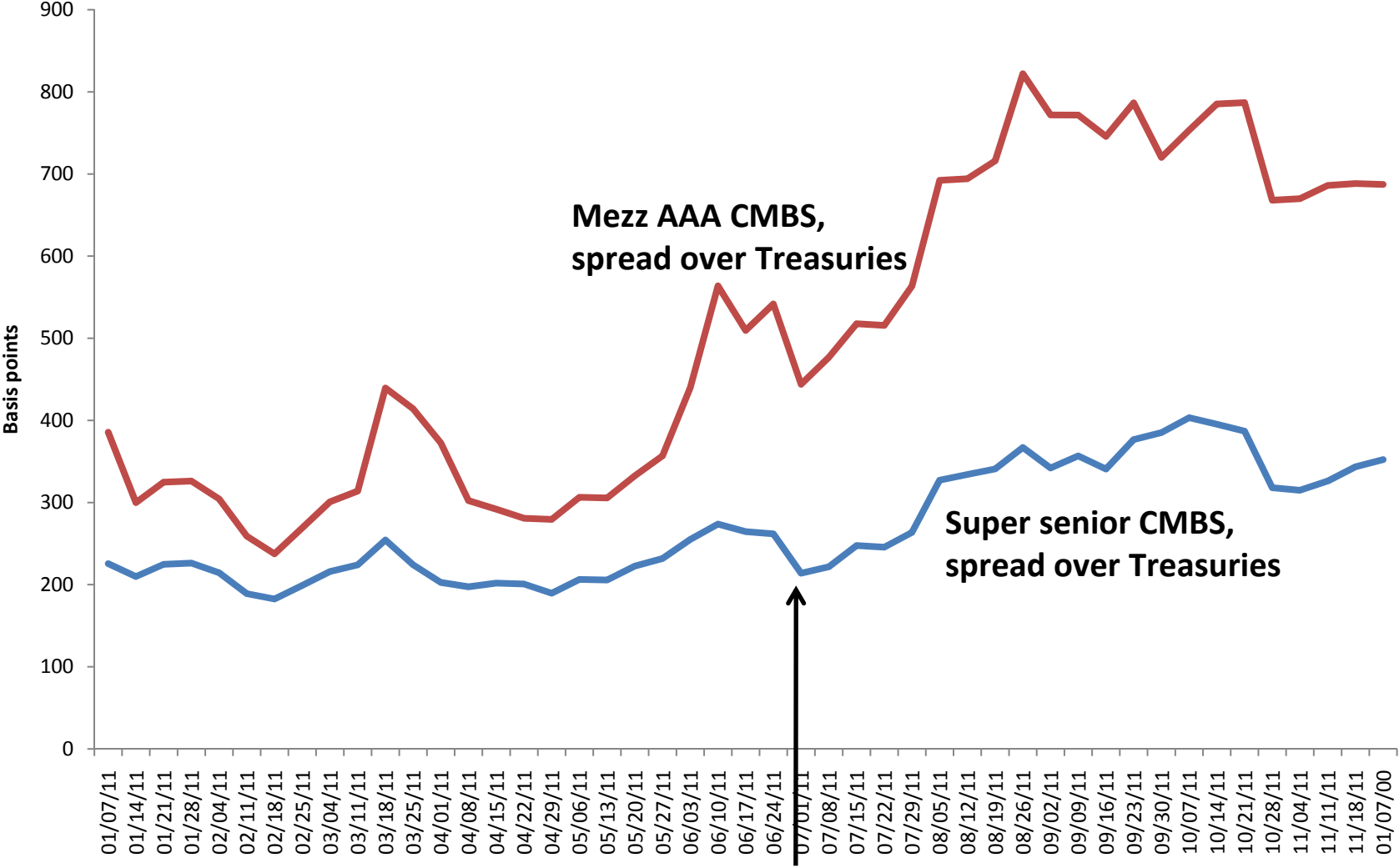
VIX - The Fear Gauge



10 year Treasury yield



Comeback in CMBS?...Maybe not.

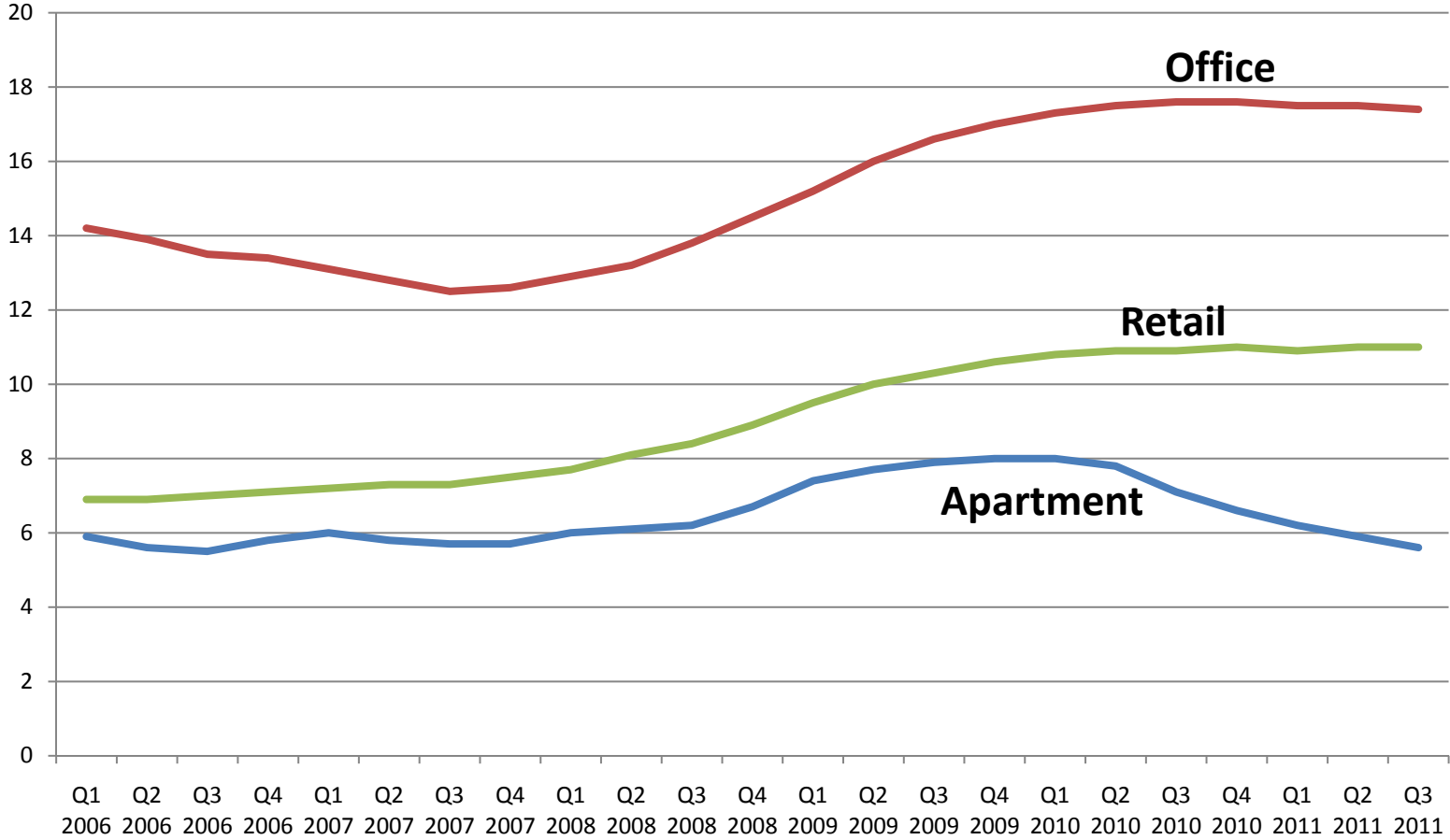


Summer market volatility starts

Based on 10 year CMBS.
Source: JP Morgan

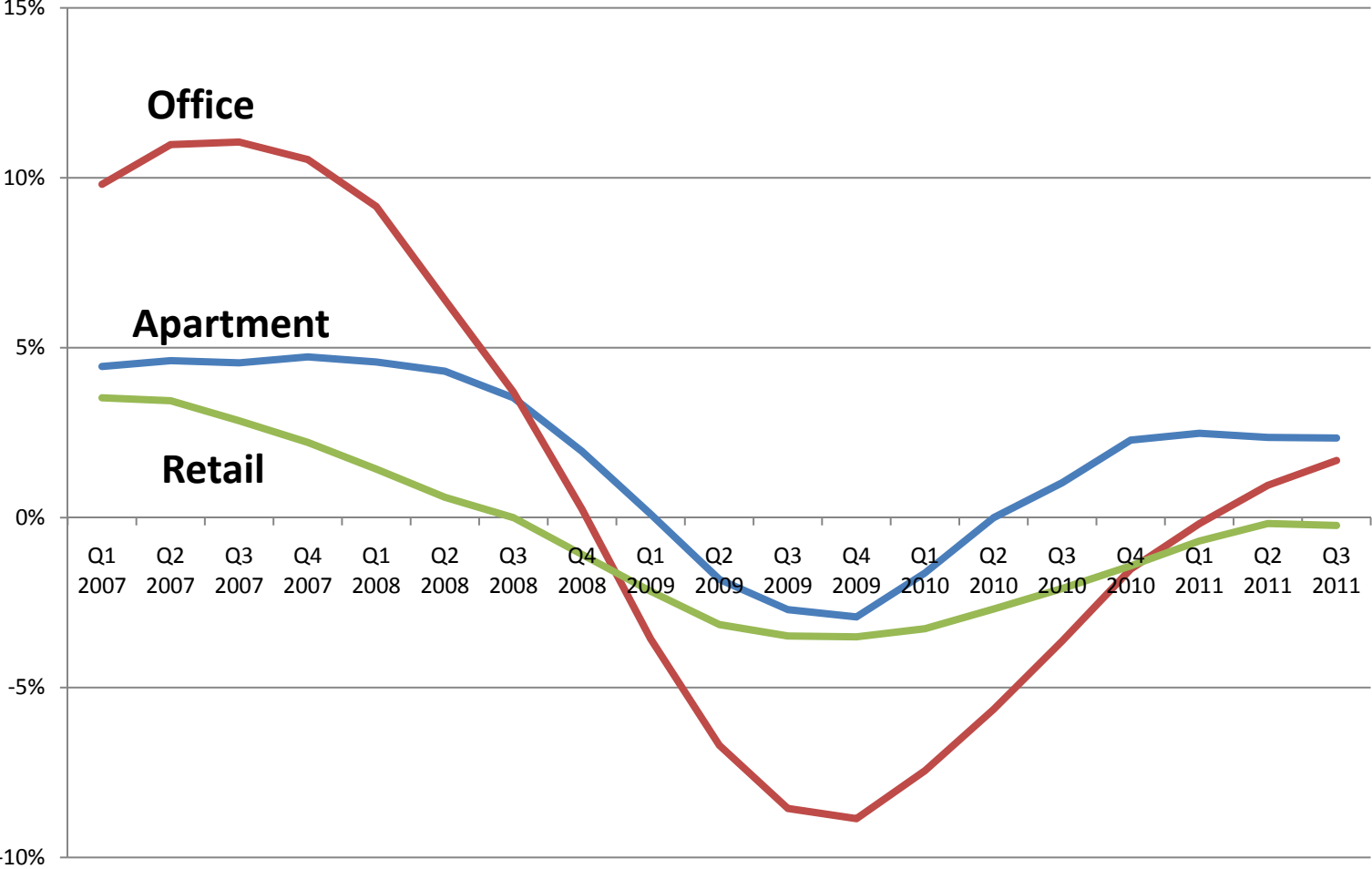
Real estate fundamentals at inflection point?

Vacancy



Source: REIS

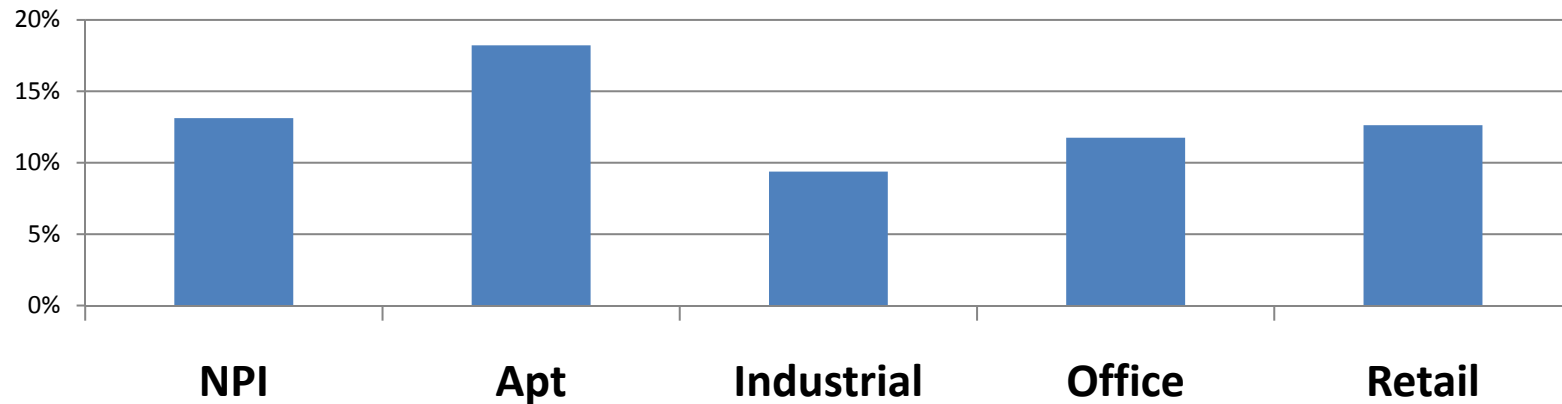
Real estate fundamentals at inflection point? Year-over-Year Rental Growth



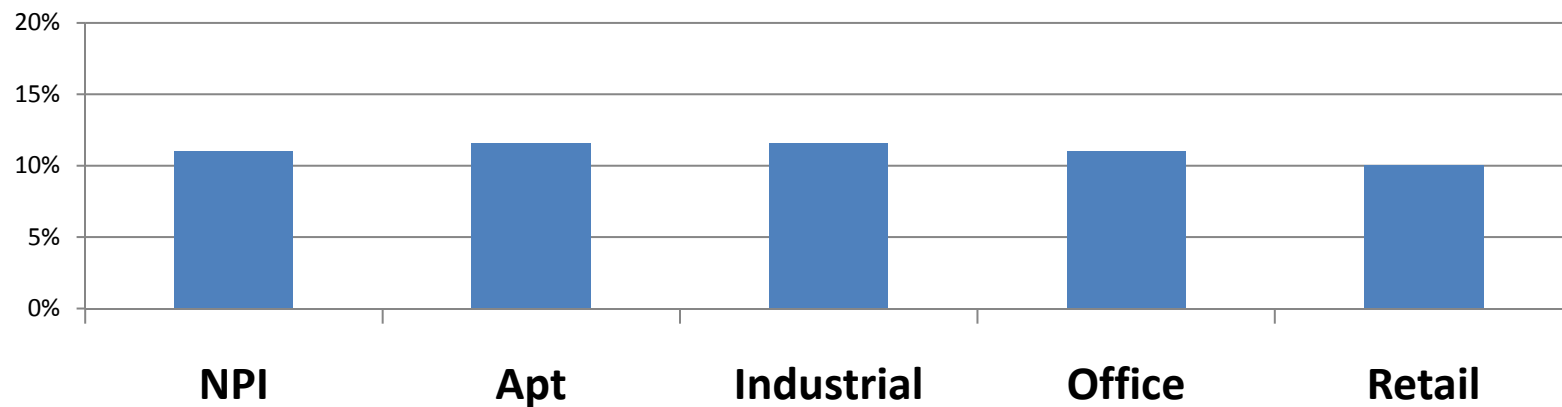
Source: REIS

NCREIF Property Index (total returns)

2010



Year-to-Q3, 2011

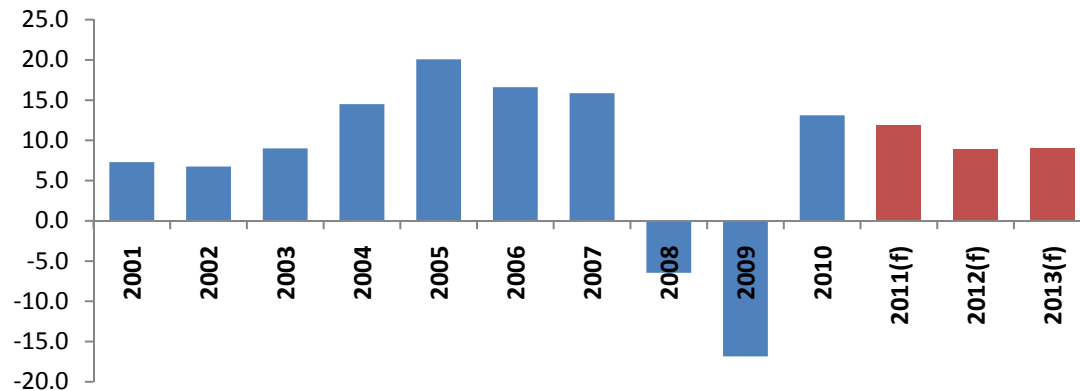


Going Forward...

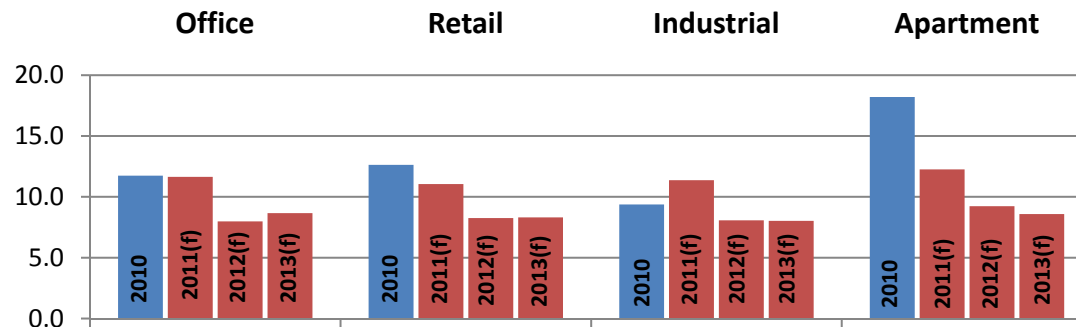
PREA Consensus Forecast

- survey of 20 large investment managers & research firms, following Q2 results
- returns expected to decelerate through 2012/2013, but back to long term average
- “slowing but still healthy”
- apartment expected to lead pack again in 2011 and 2012

NPI total return incl. income

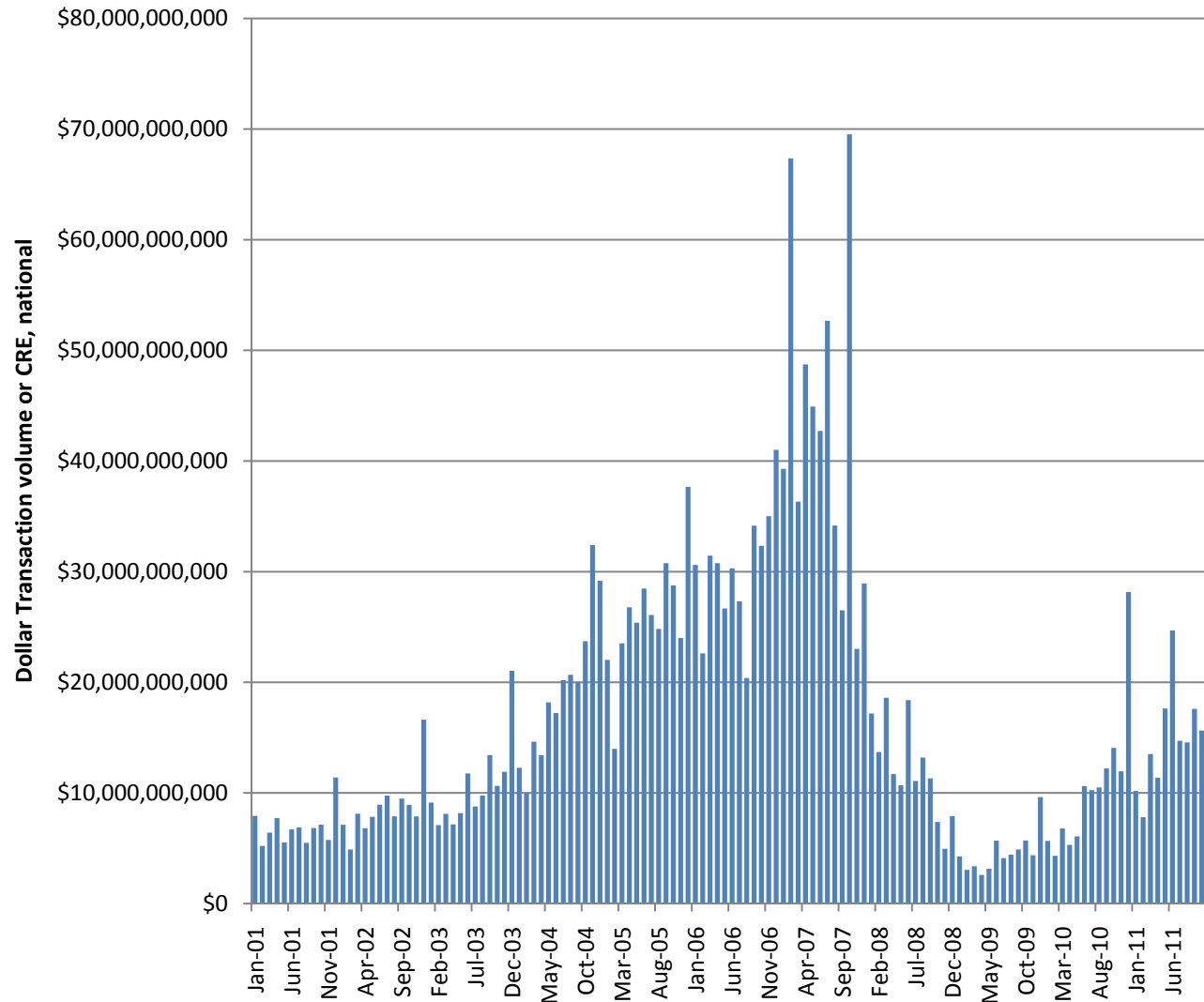


Average Forecast Total Returns, by Property Type



Transaction volume up, but trend slowing

- transaction volume has continued to grow
- upward trend slowing due to capital market volatility
- Oct '11: lowest year-on-year increase (11%) since transactions began coming back
- But, graph hides where the action has been



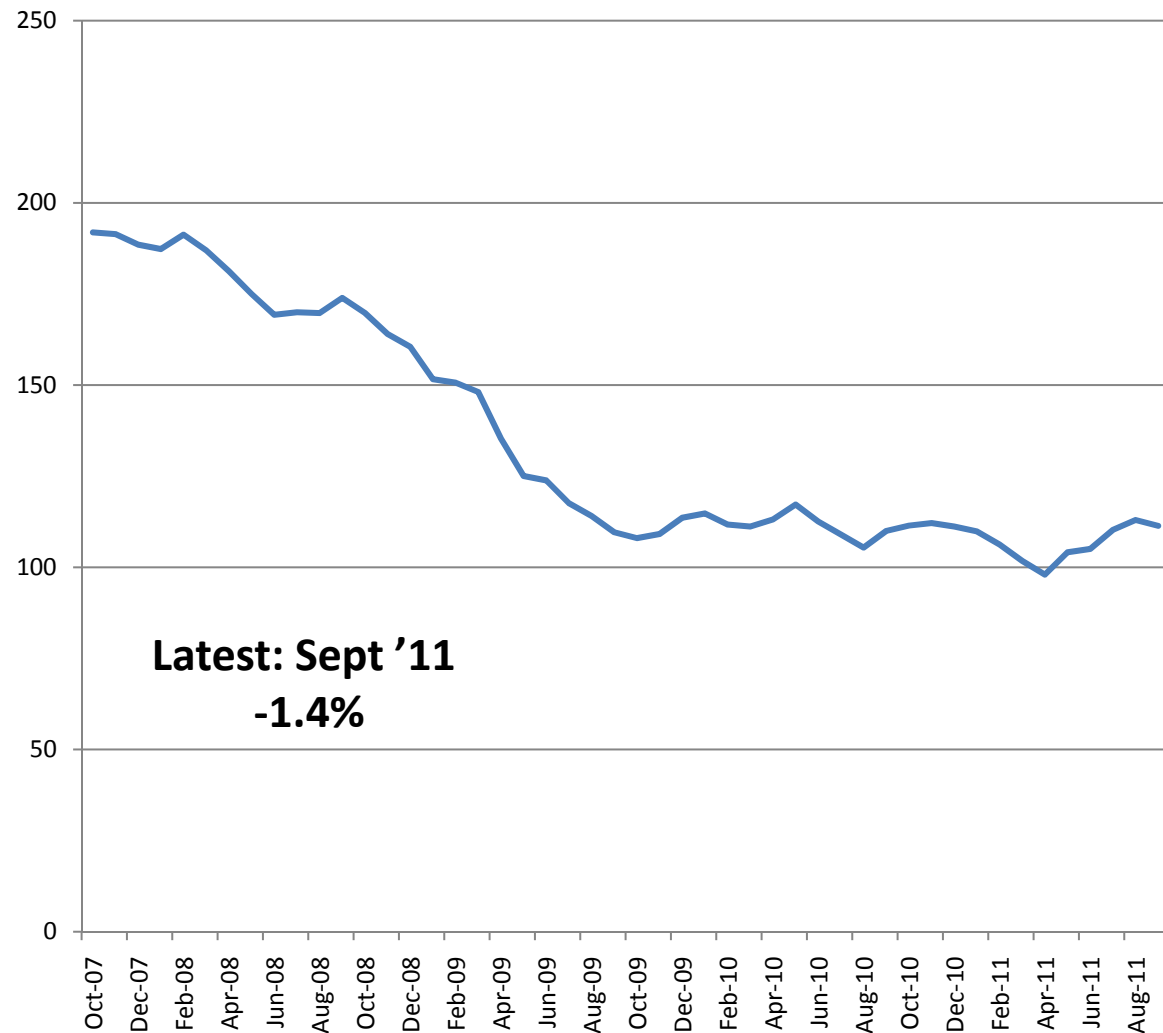
All transactions over \$5 million.
Source: Real Capital Analytics

A More widely based CRE index: Moody's/REAL CPPI

- all transactions over \$5 mill.
- price-only index

• prices have largely bounced along bottom since crash

• September showed decline following four months of gains



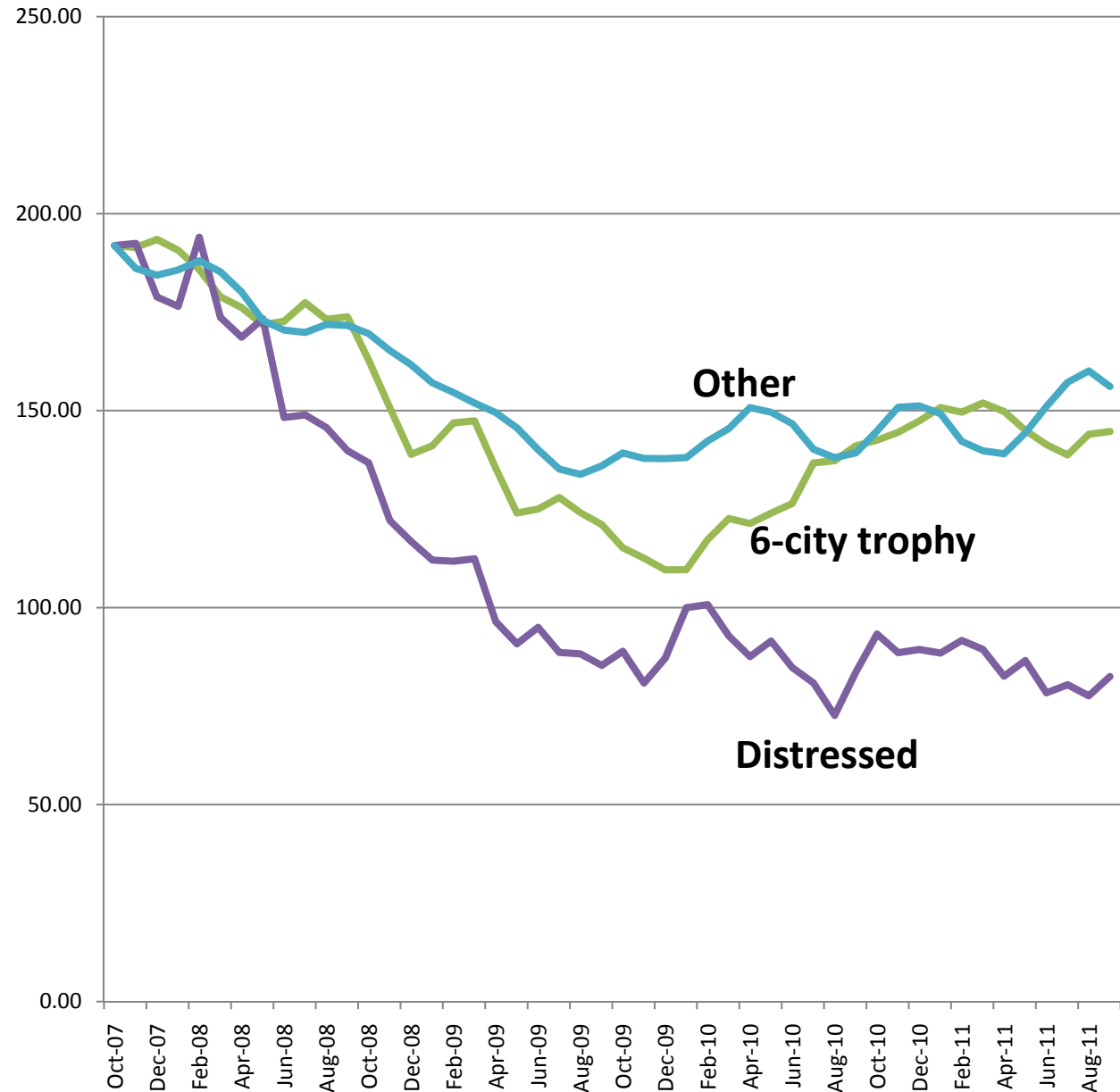
Source: Geltner Associates, REAL, RCA

“Trifurcation” of the market

- “6-city trophy” = over \$10 mill., in NY, SF, LA, Boston, Chicago, DC

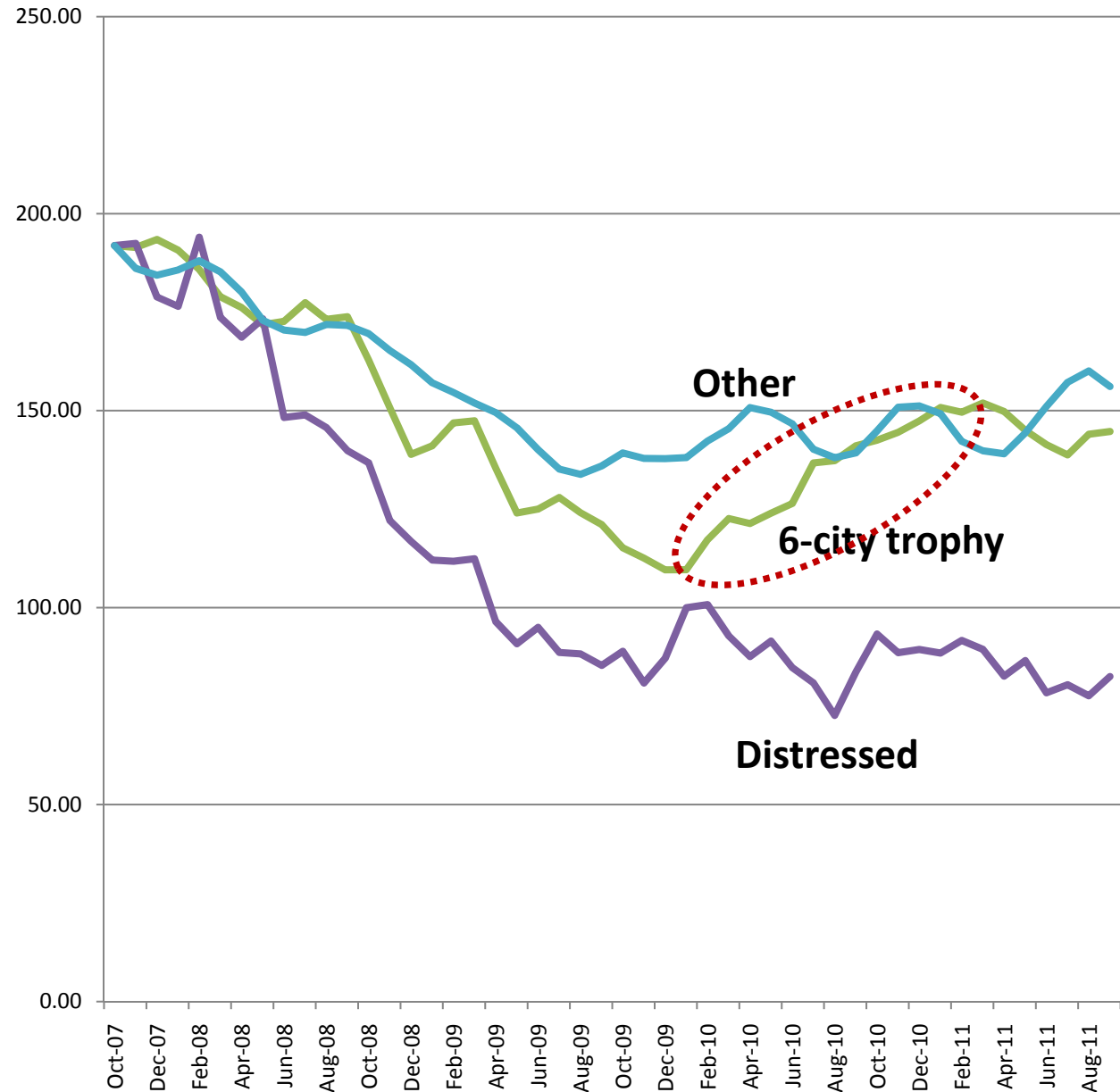
- different parts of the market have performed much differently

- distressed properties still languishing



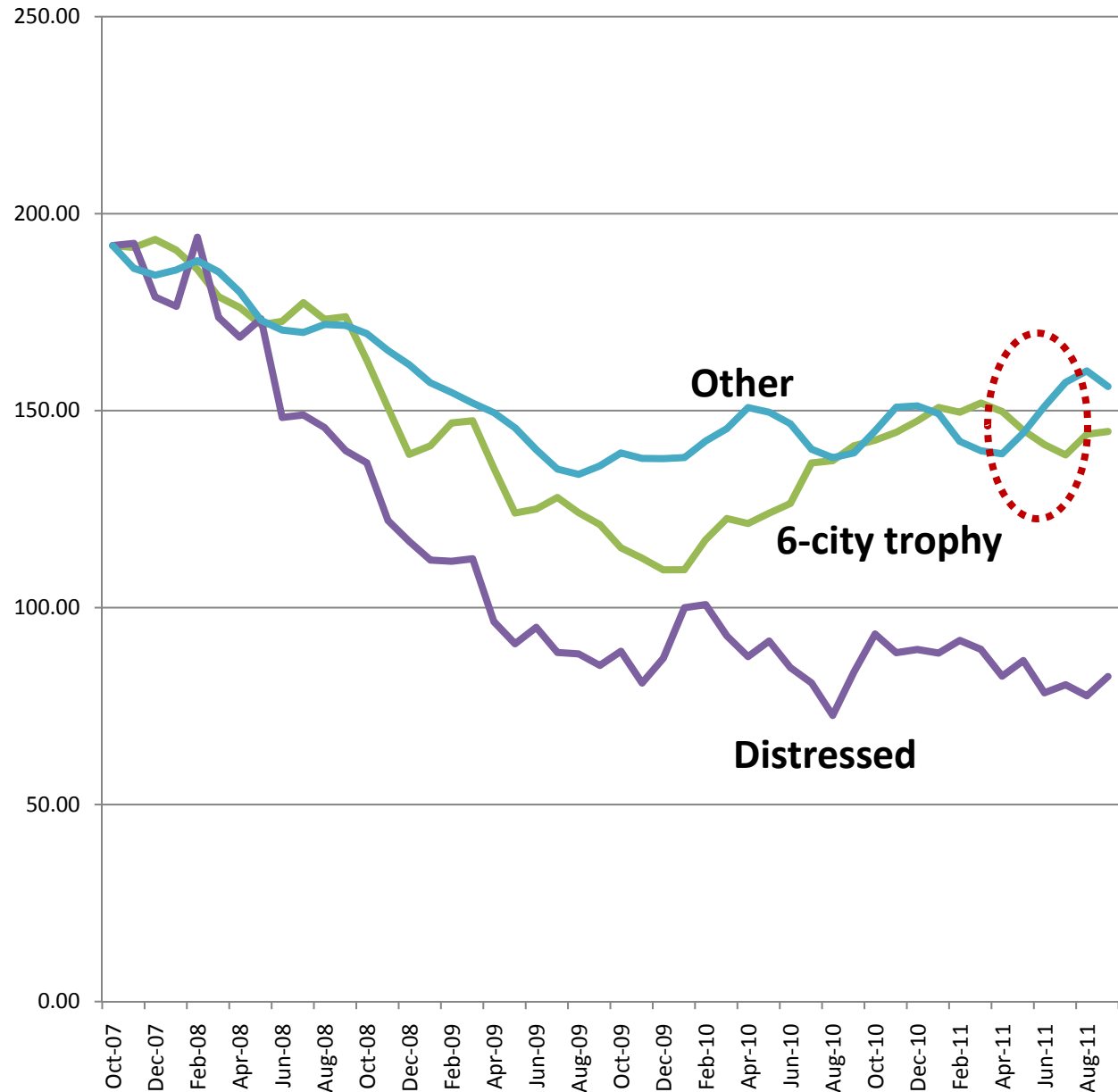
“Trifurcation” of the market

- big run up in prices in six “gateway” cities
- Dec ‘09 to Mar ‘11: 39% rise
- institutional flight to perceived safety
- major cap rate compression, but only in those select markets
- remainder of US remains near bottom



“Trifurcation” of the market

- first half of this year, institutional investors started to look beyond six cities
- high prices for high quality core pushing institutional capital to secondary markets
- real estate recovery began to widen

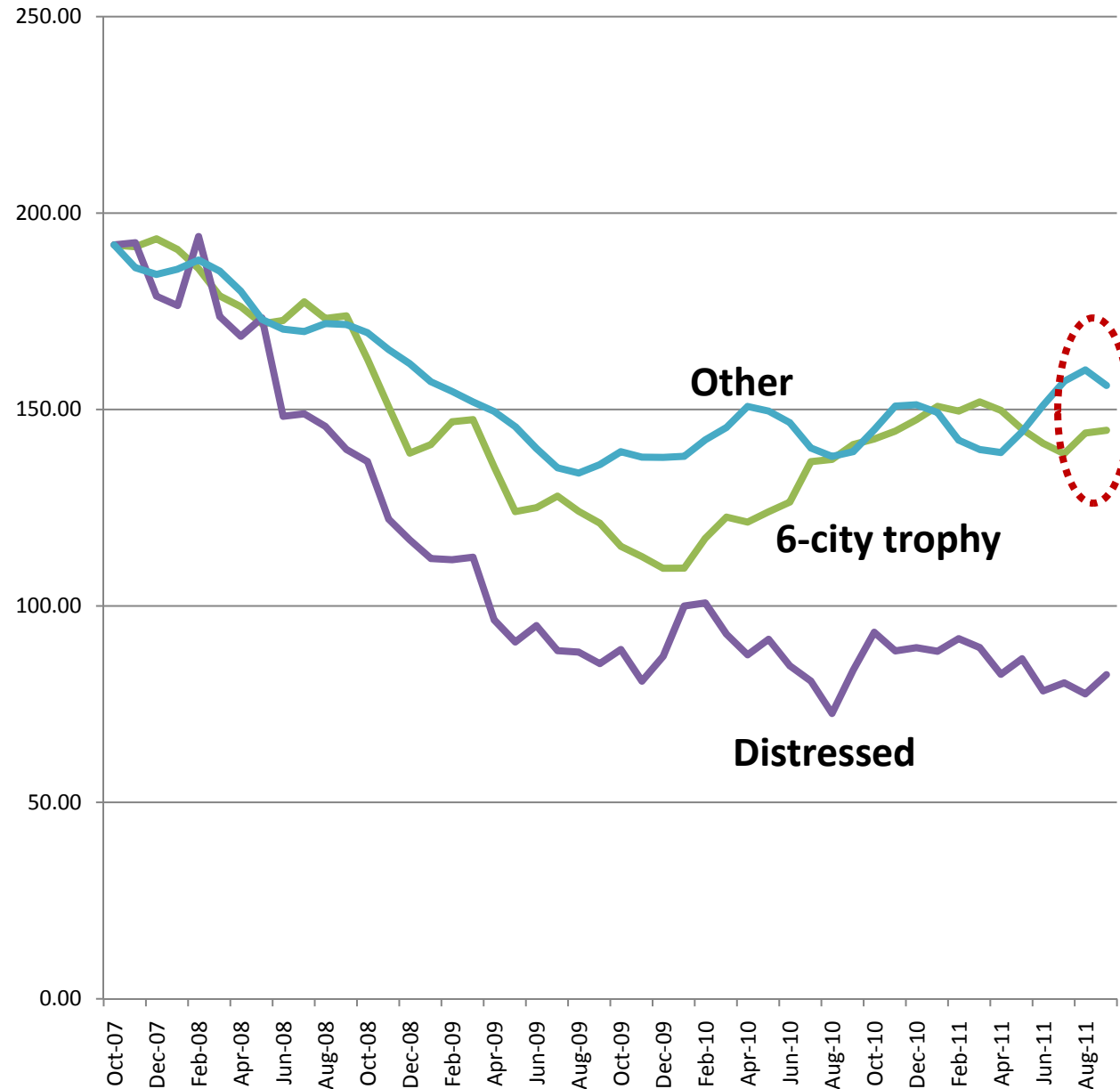


“Trifurcation” of the market

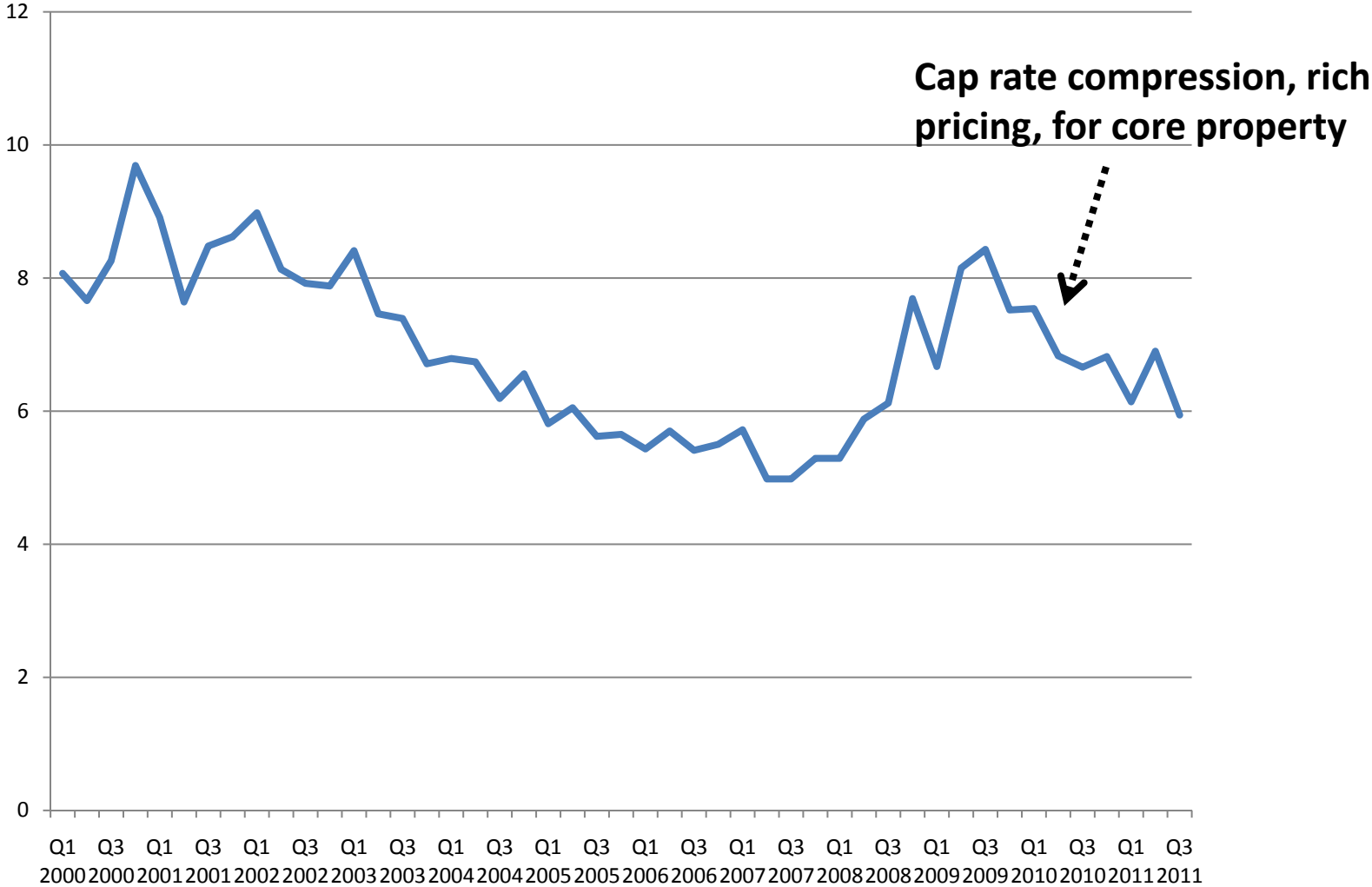
- most recent, capital market volatility and economic uncertainty

- flight to safety renewed?

- may need sustained economic recovery, less capital market volatility, for sustained broadly based recovery in real estate values



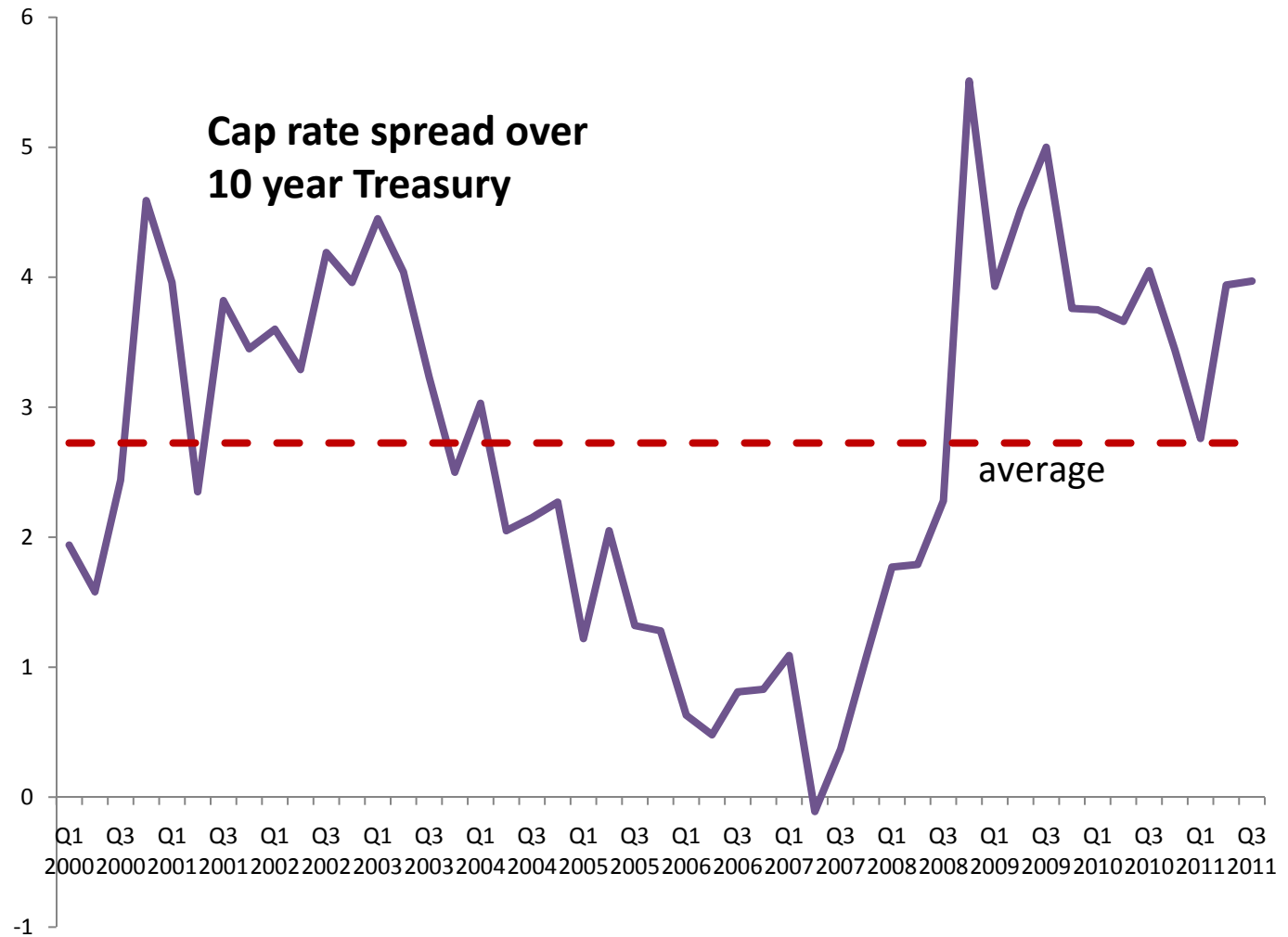
Transaction Cap rates of institutionally held properties



Source: NCREIF

But, for institutions, everything is relative...

- real estate must compete for institutional capital with other asset classes
- in low interest rate environment, core real estate continues to look relatively good
- even with compression, spread over Treasuries somewhat above average



Source: NCREIF, Federal Reserve Board

Issues for Institutional Investors in Today's Climate

- Post-crisis, institutions remained committed to real estate as an asset class.
- PREA Investor Report 2011:

Expect no change in allocation in 2011	79%
Expect an increase in allocation in 2011	15%
Expect a decrease in allocation in 2011	6%

Issues for Institutional Investors in Today's Climate

- Public plans, still pressure to meet 7% to 8% required rates of return on portfolio
 - Difficult with low interest rate environment, equity market volatility
 - Allocations to alternative investments, including real estate, continue to gain.
 - Good returns, relatively low risk.
- BUT, investors conducting more careful due diligence, taking longer to commit, examining fees carefully.

Issues for Institutional Investors in Today's Climate

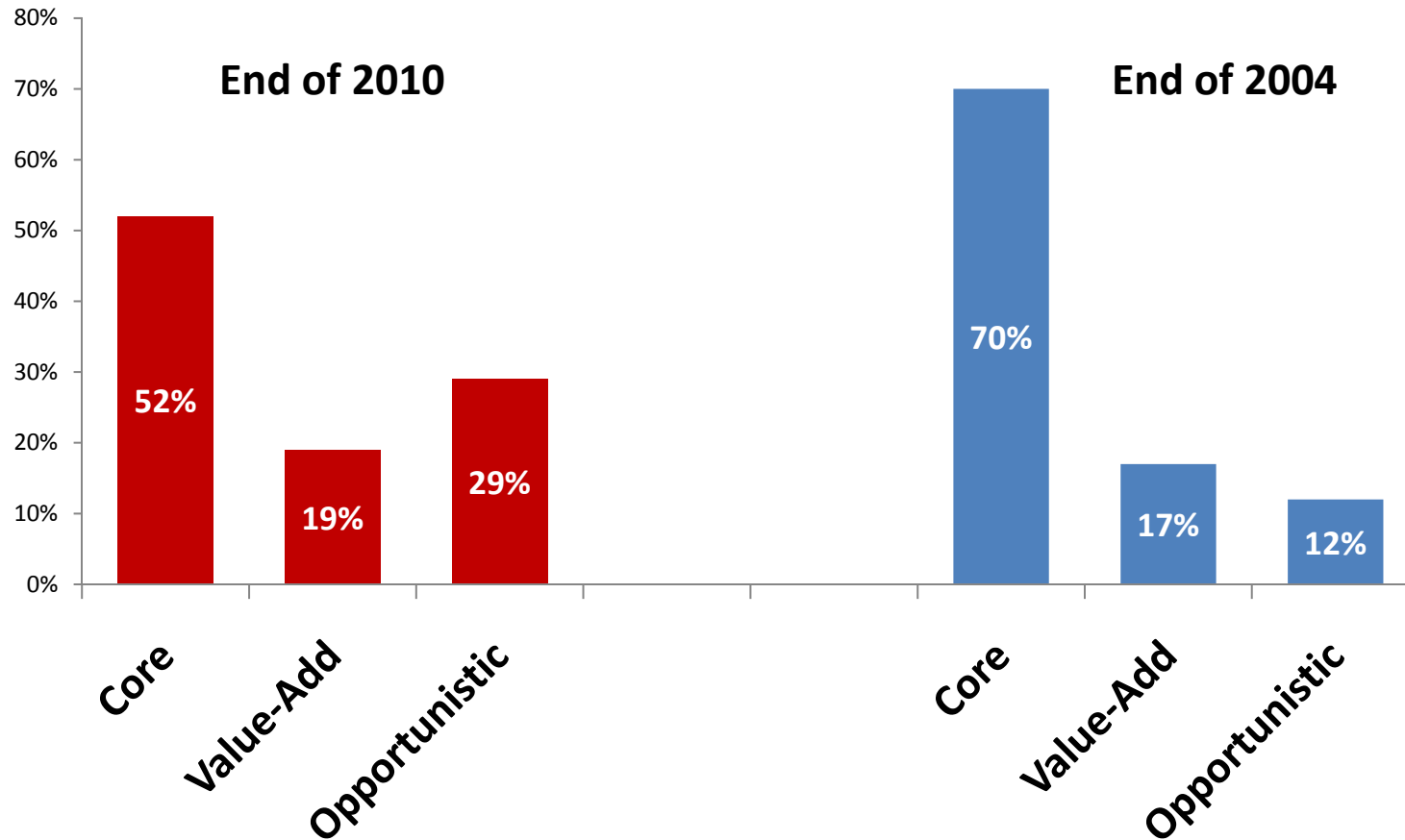
- Major post-crisis issue for real estate:

RISK

- Managing it, measuring it, understanding it, generally reducing it
- Flight to safety = core markets
 - Perceived safer, and more liquid
- 82% of institutions interested in core investments (Source: Preqin)
- Eye on global events/market volatility
 - Realization that real estate no longer just a local business

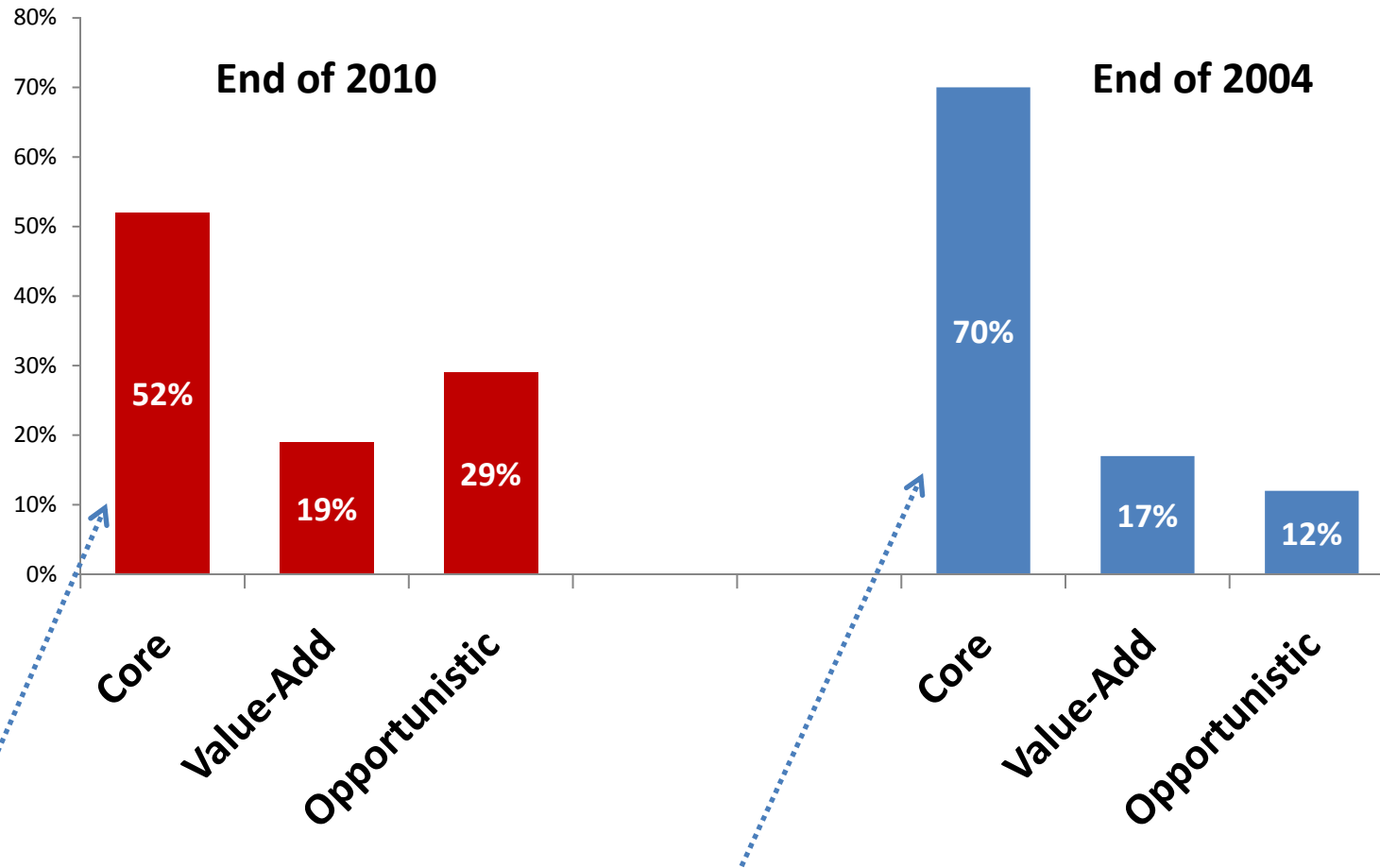
Move to core is partially a return to normal

Distribution of real estate portfolio by strategy



Move to core is partially a return to normal

Distribution of real estate portfolio by strategy



Expect this to increase...

...but still less than pre-bubble.

Concern with use of debt financing and effect on risk exposure

Plan sponsor's reporting change in leverage from 2009 to 2010	
Decrease	56%
Increase	23%
No change	21%

- Is leverage really creating any value, or just amplifying returns - both up and down?
- Investment managers increasingly need to justify use of leverage.

Where to from here?

- As cap rates compress in core markets, natural tendency to look for yield elsewhere
- But for this to happen, likely need a period of reduced volatility, sustained growth
 - Otherwise, flight to safety into major markets may continue
- Once global economy turns corner, first debate that arises: Class A properties in secondary markets versus Class B vs. class in primary
 - Saw this question start to be asked during H1 2011, no universal answer
- When does a broader market recovery start to happen?
 - Depends a lot on broader global economy, and on political decision making.
 - So don't ask me.