Delta *Outlook*

A market report for commercial real estate executives

Perspective on the August 2007 Credit Crunch: Outlook for the Economy and Real Estate Market

We are being greeted by a new landscape, as we return from Summer break: a bewildering new world of the post-August 2007 Credit Crunch. What is it, how did we get here, and most important, what does it mean for those of us in the commercial real estate business? Our purpose here is to shed light on these issues. We wish we had answers to all aspects of this puzzle. But from our discussions with dozens of economists, financiers, clients and colleagues, as well as our evaluation of the market, we detect a pattern of thought and a direction to our economy and industry that is beginning to emerge.

What Happened? What Is Next?

Where did all the liquidity go? And what do sub-prime mortgages have to do with commercial real estate? Buyers of bonds securitized by real estate assets have lost faith in the value of the collateral behind those bonds. It started with pools of residential mortgages but has spread to other asset classes. Once spread, the bond market seized up like an over-heated engine. The Fed increased liquidity and lowered inter-bank borrowing rates to help cool and restart the engine, but that will go only so far. We need faith again in the valuation of the collateral that secures these bonds. That will take time and re-pricing. Our view is from 120 days to perhaps well into the first quarter of 2008.

In the meantime, the consensus of those with whom we speak is that **commercial debt** is very hard to come by. Life companies have money at very low loan-to-value ratios for existing low-risk deals. Banks are balance-sheet lending on a short-term basis with floating rates. Leveraged buyers are out of the market – for now. Those with patience and cash appear to have opportunities. Those with assets under contract are **re-pricing** – up to 10% for weaker deals in lesser submarkets. Unworthy deals or those that were simply over-priced are falling apart.

Impact on the Economy?

Before the Credit Crunch we had been predicting slow but sturdy economic performance in 2007 (~2.5% GDP growth) followed by a slightly more robust 2008 (~3.0% GDP growth). In fact, economic indicators through July looked quite promising. We feel the Credit Crunch has pushed off the 2008 rebound to 2009. So, 2007 and 2008 are likely to look and feel similar – in the 2.5% GDP growth range. For this to happen, the Fed may need to weigh in with a rate cut in the Fall/Winter of 2007/2008.

While high energy prices, the housing market downturn, and more costly credit threaten to bring a recession, other factors suggest continued economic growth. These include a more mature manufacturing sector that is not likely to drag down the economy as much as in prior downturns; the increasing likelihood of a cooperative Fed (based on Chairman Bernanke's recent statement: "The Fed will do what it takes..."); continuing record-setting corporate profits; and continuing job growth – notwithstanding the pause in August – that suggests employer optimism and healthy underlying economic fundamentals. In addition, construction of public projects at the state and local levels is up 11% this year over last, bolstering the economy and helping to offset the slowdown in residential construction. ***In sum, we do not foresee the Credit Crunch bleeding into a general recession.***

Impact on Real Estate?

Let's start with ***the housing market***. Notwithstanding reports in the popular press to the contrary, it appears that there remains plenty of mortgage money available for conforming loans for credit-worthy borrowers, and at interest rates not materially different from those quoted over the past year. Even jumbo loans for high-credit-score borrowers are available, although at elevated interest rates. But for the most part, gone are the days of easy credit for high loan-to-value borrowers of all types and loans to low-credit-worthy individuals. Exotic loan products seem to have disappeared, and investors have been out of the market for 15 months. As a result, up to 25% of the market for homes has disappeared in the past year. At the same time, those who remain in the market are hesitant to make a commitment because of the fear of falling prices. And yet, despite all the uncertainty, the Mortgage Bankers Association's weekly index of mortgage applications shows that demand for loans generally was rising over the past few months. The result of all of this, in our view: ***the embryonic recovery we were witnessing in the Spring and early Summer of 2007 in most metro markets will fade and meaningful recovery is now postponed to 2009.***

We think the apartment market is a winner in this process, at least in the intermediate to long run. The reason: the home ownership rate will ease back from the current record level of 70% nationally to 67% or so. Correspondingly, rental **occupancy** will rise and the apartment industry will benefit to some degree – at least to the extent that this increased demand is not satisfied by the "shadow market" of former owner-occupied housing that soon will be put up for rent. It is possible that the owners of Class B and C apartments will benefit most, as cash will be tight for sub-prime residential borrowers moving to rental units, but Class A apartment owners should reap some benefits as well.

In addition, developers and owners of existing apartment product may benefit from postponed development projects that now may struggle for sponsorship and financing. We have heard from many of our stronger apartment clients that they believe they will benefit at the expense of weaker players, and that public builders in particular are temporarily out of the market. Some even dream that **land prices** might stop their inexorable march upward, though that remains to be seen.

With condo conversions no longer in play, **apartment cap rates** are reportedly under upward pressure as capital markets sort out. Will this lead to downward pressure on prices? Some of our buying clients report a 15 to 40 basis-point increase in cap rates for good product at strong locations; others a 25 to 75 basis-point increase for weaker product at lesser locations. Our selling clients report no cap rate change, with prices as strong as ever. This buyer/seller disconnect may explain why so few deals have been inked in the four weeks following the beginning of the Credit Crunch.

The national office market is affected by the problems in the credit markets. Watch submarkets in metro areas that are highly dependent on the homebuilding and home mortgage industries. This could include submarkets in Orange County (California), Phoenix, and Denver, to name a few. But nationally, supply/demand conditions are sturdy and should remain generally unaffected in the short to intermediate term by the Credit Crunch in terms of **occupancy** and **rental rate** trends. If anything, occupancy in the intermediate term might benefit (on a national level) because it is now more difficult to finance development, so development deals on the sidelines are more likely to remain there until the current Credit Crunch is resolved.

Asset re-pricing seems inevitable, however, if **office cap rates** rise. Most of our clients report an expectation over the next year of a 10% price decline or 50 basis-point increase in cap rates. Is that enough to return replacement cost as a benchmark in the acquisition calculus?

The retail market will feel the impact of tightening credit. As a result of housing and financial market turmoil, consumer sentiment took its largest one month drop in August 2007 since Hurricane Katrina. Combined with the "mortgage ATM" being put out of business lately, consumers will probably make the 2007 holiday selling season a disappointment to retailers. We expect retailing in general to have a lackluster year in 2007.

Nevertheless, we still find real **opportunities** in those metro areas with high barriers to entry (like New York and San Francisco), or high growth rates (like Dallas, Houston, and Phoenix), or both (like Washington and Los Angeles). From a sales perspective, unleveraged buyers now have a chance to be more competitive.

How Long Will the Credit Crunch Last?

Our view is that this Credit Crunch is temporary. But it will take another 120 days for enough smoke to clear to really have a better sense of its impact. We will issue additional reports as needed to keep our clients and colleagues fully informed.

Spoils will go to those with patience and cash. The crunch will end when faith is restored in the value of the collateral behind the bonds that make up so much of our fixed-income marketplace. That may happen before we fix the system – the "Big Three" credit rating agencies reporting to buyers, rather than sellers; better parsing of risk; and better transparency. It will likely come with a large influx of cash to buy those frozen assets, thereby setting a new price for risk. We think that is likely to take 120 to 180 days. In the meantime, we are optimistic that the Fed will bolster general market and economic confidence by adding liquidity and a rate cut as early as this Fall. It is encouraging, too, that the President has weighed in with proposals to get FHA involved with assisting credit-worthy sub-prime mortgage holders and there is discussion of lifting insurance caps on Freddie Mac and Fannie Mae.

As explained earlier, we do not see this Credit Crunch bleeding into a national recession.

In our view, assets of all types are in the process of being re-priced. The decade-long cycle of cap rate decline is likely over, so ***price increases in real estate assets will be won the old-fashioned way – by improvement in cash flow performance.*** We see plenty of opportunity for that, in contrast to the early 1990s, as supply/demand fundamentals are attractive in most metro markets for most property types.

Apartments are likely winners in this process.

The impact on the office market is a push overall, but look out for some soft pockets.

The for-sale housing market is in for another 18 months of adjustment, but with continuing opportunities to serve a growing population in select strong markets. Close-in, high-value submarkets are particularly attractive even when the surrounding metro region appears to have a lackluster housing market, such as Coral Gables (Miami), Highland Park (Dallas), Bethesda (Washington), West LA, and Pacific Heights (San Francisco), to name a few.

Notwithstanding our general pronouncement that retail may suffer some, retail is a localized market and warrants closer analysis at the local level.

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While we do not know what the future holds, we hope you find this considered reasoning about the future helpful to your business planning as you return from a Summer break. If we can help you with research or market studies, or with a presentation to your board, please call on your service partners at Delta Associates.

Until then, may you find ways to capitalize on shifting market conditions.

Delta Associates

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1. ***Valuation*** services for partial interests in commercial real estate assets.
2. ***Consulting***, research and advisory services for commercial real estate projects, including market studies, market entry strategies, asset performance enhancement studies, pre-acquisition due diligence, and financial and fiscal impact analyses.
3. ***Subscription data*** for select metro regions for office, industrial, retail, condominium and apartment markets.

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