

## So, what do we do now?

The last few issues of **GA** have been devoted to the economic crisis. In November, we talked about the quickly unfolding economic news, and particularly focused on what we thought would be the next shoe to drop – a credit card crisis. That's slowly coming upon us, and we hear that at least one credit card issuer – American Express – is now offering to pay otherwise creditworthy card holders to cancel their accounts. It seems that Amex's potential commitments on their transaction cards far exceed their own ability to borrow from their credit sources. I'm sure we all know how they feel.

In December and January, my colleague Dr. Max Kummerow wrote about the economic "big picture", with a particular emphasis on the implications for residential pricing and values (which are currently in disequilibrium with one another). This month, and for the next several months, we'd like to focus on investment-grade real estate, and discuss the implications for portfolios and investors.

Note that all of this depends on the underlying economic "reality" and assumptions about the near-term trends. We'll be very specific and explicit about how this all affects our observations.

Please note also that these are general observations about the economy, and should in no way be construed as investment recommendations for particular investors in particular situations. If you have specific questions, please don't hesitate to contact us, but possession of this newsletter does not constitute a client relationship with Greenfield Advisors or any of its affiliates.

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## Buy, Hold, or Sell?

Naturally, implications depend significantly on individual portfolio implications. We'll start with the existing portfolio. Is it a good time to sell, to hold and ignore, or to buy more?

The answer to the first part of the question is pretty easy. Particularly in the residential sector, unless you have to sell, now is a good time to hunker down and weather out the storm. However, if you do have to sell (estate settlements, need to book some tax losses, etc.), be aware that it is clearly a buyers market right now – too few dollars chasing too many properties, too many of which are offered at distress-sale prices. If we were in an "up" bubble in prices a year ago, then we're surely in a "down" bubble now, with prices disconnected on the down side from true, intrinsic values. This means that timing and positioning are everything, and sellers who are in a position to make non-financial concessions (seller financing, etc) will come out better than most.

As to "hold" strategies, particularly in non-residential, income-producing property, now is a critical time for a property-specific analysis of investment specifics. Many office, retail, and industrial properties are undergoing tenant re-negotiations. In past real estate recessions, many investors have made short-term investment management mistakes which turn into long-term management and valuation problems. *In the next couple of months, we'll address some specific "sell" and "hold" recommendations for optimize investment-grade holdings during the current recession.*

Everyone agrees it's a buyers market in real estate right now, but that doesn't mean that every opportunity is a "buy". Some sectors (both property type and geographic sub-market) have great fundamentals, while others are problematic. In upcoming weeks, we'll deal with some of the specifics, but for now, let's take a quick overview of property-type sectors and how they should react in the near-term.

## Sector Analysis – Not all Sectors are Created Equally!

It's now fairly well known that dislocations in the housing sector were the straws that broke the camels' backs, thus starting this economic downturn. What is less appreciated is the ripple effect being felt throughout the real estate market.

First, a quick historical overview: Easy money and sometimes slack lending practices led to a disproportionately high home ownership rate in the U.S. – at one point recently hitting 70%. Economists don't necessarily agree on the right proportion of households which should/can own homes, but we've heard 60% by some pundits, and there's some intuitive sense to that. This means that about ten percentage points, more or less, of the owner-occupied housing stock has no underlying economic demand. We'll get back to this point in a minute.

The economic melt-down came as secondary- and tertiary-effects followed what would otherwise have been a fairly normal cyclical downturn in housing demand. If we were in the America of a decade or two ago, the recession would have stimulated a modest increase in foreclosures, but nothing like what we're seeing today. The current problem arose because the investment banking community – an intertwined, under-capitalized house-of-cards to begin with – constructed collateralized mortgage obligations and proceeded to fund them with almost totally borrowed money. Thus, even a slight increase in the foreclosure rate – a wholly predictable economic cyclical event – brought the whole world's economic structure to its knees.

Since the whole world's credit markets had become so intertwined, banks and other traditional lenders (insurance companies, trusts, pension plans, etc.) found themselves holding mounds of bad paper, with demands on their own liquidity, and thus an inability to issue any new credit until they could get some liquidity out of the old, bad paper. Making it worse, many regulated lenders have minimum credit standards. Writing off a bad loan means writing off some of the book value of their capital, which brings them out-of-sync with their regulatory capital requirements. TARP and other emergency infusions only serve to bring the old capital up to par, but doesn't create enough new capital to allow banks to start lending again. Back to Econ 101 – this breaks the circle of banks lending, which creates deposits, which allows banks to lend. If banks can't lend, deposits naturally collapse and we're into a negative feed-back loop.

So how does this affect housing as an asset class? Two ways. First, housing and housing related companies are selling at prices which are often disproportionately low compared to intrinsic value. On the retail level, one-off investors can get great deals on distressed houses and small investment properties (one-to-four family residences). Getting good financing is problematic, but cash investors will be able to "cash out" when the market recovers and find that, if they were careful on the buy-side, the properties will be worth considerably more than they paid for them. Secondly, on the wholesale side, there are potentially three plays: homebuilders, development companies, and development tracts. These require careful market research. Some homebuilders will emerge from this in great shape, and well-capitalized investors can aggregate several of them into a nice investment pool. We saw this happen during the S&L crisis nearly two decades ago, and aggregating investors made out very well.

The key to this will be patience and staying power. Very few homes are being built today, but with population growth (particularly on the two coasts), demand will come back in the future. Thus, even though the overall percentage of households owning homes may decrease, the increase in population will push marginal demand back into positive territory in a few years.

In the meantime, this leads to the substitute good for housing – namely apartments. Both total and marginal demand for apartments are on the rise, and should continue so for the foreseeable future. A combination of an increasing number of households, combined with a shrinking marginal demand for owner-occupied housing, will bouy this subsector for years to come.

However, not all apartments are created equally. Much of the short-term apartment supply will come from unsold condominiums

and failed condo-conversions. This will usually appeal to the upper end of the apartment spectrum, but this supply will typically not address the lower ends of the market. In addition, a large portion of the apartment stock in the past few years has been subsidized by low income housing tax credit finance, HUD Section 221-d lending, and tax exempt bond finance, and other subsidies aimed at increasing the stock of affordable apartments. The credit market meltdown has put this sector into a tailspin, primarily due to the temporary “halt” in the tax credit markets. While the debt side of the market is still healthy (particularly the HUD 221-d programs), the not-for-profits, which have historically been major players, are temporarily out of business.

This means that investors who understand the HUD programs can get a great deal of leverage (in some cases, 90% LTV) for apartment investments which are aimed at a growing demand. While this is a management-intensive arena, this sector provides significant stability, rent growth, and resale potential. The downside? There are pre-payment penalties for the first 5 years (221-d) and in some cases, the properties have to be kept in the program for as long as 15 years. On the other hand, there is usually a ready market for sale of these properties, and development sites can be acquired at fire-sale prices today.

## Non-Housing Sectors

Other “common” real estate sectors include industrial, retail, office, and hotels. The “non-common” sectors now-a-days include all sorts of intriguing property types, including infrastructure investments, wind farms, for-profit highways, multi-modal transportation infrastructure, mines, and “trophy” ranch real estate. We’ll deal with many of these in future issues of **GA**. For the time being, we’ll stick with “core” real estate.

The office sector probably hasn’t hit bottom yet. There is still a lot of re-negotiation going on in the system right now. Investors are faced with the terrific problem that the interests of their property managers may not coincide with the long-term value benefits of the investment itself. *Next month, we’ll deal with some “hold” strategies to help optimize long-term value of office properties.* In the meantime, investors interested in office properties would probably be well advised to shop carefully. There are “deals” out there, but they’ll require a fair amount of analysis.

Waiting for the market to transition to an up-cycle may be the best overall strategy for an active investor with cash. During the current down-cycle, many “A” and “B” grade office properties will get tenanted with “C” or worse tenants. Leases will go from long-term credit status to short-term or month-to-month. Short-term maintenance will suffer, as will tenant improvements, and landlords will be strapped for cash. When the market turns back up, investors will be able to pick up “C” buildings that can be transitioned to “B” or better status. These transitions will usually be quicker to meet growing “B” and “A” demand which will surface when the market turns back up (as opposed to new construction, which will be slow to catch on.)

The industrial sector may be even worse hit. A lot of logistics infrastructure got built in the past couple of years to accommodate the “balloon” of retail that comes in from Asia and gets sold in the Christmas rush. In an attempt to smooth-out the annual lump in the system (it’s cheaper to build warehouses than docks and ships), the idea was that the supply train could run all year, and be stockpiled in warehouses here in the U.S. until the Christmas rush. Location didn’t really matter, since much of what came into west-coast ports was aimed at the east-coast. As a result, places like Omaha were great stops for containers full of Barbie Dolls.

While retail sales in the U.S. aren’t down that much, retail sales FROM Asia are in the tank. As of December, industrial production in Japan was down 20.6%, and China’s exports fell by 17.5% in January (compared to a year earlier). South Korea is even worse, and Taiwan’s industrial production, year-over-year, was down a whopping 32.3% in December. The implication of all of this is that American warehouse space, in 2009, will look bleakly empty compared with 2008 or particularly 2007.

Which leads naturally to the retail sector. It's hard to imagine a forward-looking scenario in which this sector isn't systematically overbuilt for some time to come. Depending on which taxonomy you choose, retail real estate generally falls into one of three categories: shopping malls, community shopping centers, and 'big box' stand-alone retail. (Naturally there are other categories, but the problems inherent to these illustrate the problems of the others.) Each of these categories is suffering, but for different reasons. Shopping mall problems are linked to the overall household credit crisis. As credit card usage retrenches in America, spending at shopping malls suffers. Paradoxically, many leases are attached to revenues: even if tenants "hang on" through the current crisis, net operating incomes for the real estate will suffer proportionally.

Community shopping centers are frequently 'anchored' by a one-two punch of a large grocery and a pharmacy. Both of these sectors are retrenching severely. Many community shopping center landlords opt for alternative types of anchors. In a paper I published about 17 years ago on alternative anchors, I discussed the likelihood of bankruptcy during a 20-year period following such alternative tenancy is extraordinarily high. Finally, big-box retailers are in a particularly tough place right now, especially with the Circuit City bankruptcy freeing up so much empty space.

Hotels? Even in the best of times, hotels are the most volatile of the real estate sub-sectors. As such, a properly diversified portfolio of real estate sub-types can offset the volatility and take advantage of the high potential earnings. As a stand-alone investment type, hotels only make sense for the very sophisticated hotel-experienced investor.

## Assumptions and Caveats

Underlying economic assumptions are a dime-a-dozen today. The more aggressive thinkers are suggesting we'll see the light at the end of the tunnel this summer. The glass-is-half-empty crowd (which seems to be larger right now) is saying end of 2010 or early 2011 for the beginning of a recovery. There is even a vocal minority suggesting a systemic shift in the global economy, and that we won't see a return to "normalcy" for many years to come. In general, a lot of economists got burned with overly-rosy forecasts in 2007 and early 2008. We even saw some significant positive forecasts as late as November! As such, economists who wish to stay employed and relevant know there's little professional downside to being a doom-and-gloom prophet. For that reason, we would weight what we're seeing something like 60% on the optimistic side, 40% on the pessimistic.

That translates into seeing the light at the end of the tunnel sometime in the 3rd or 4th quarter of this year. What does that mean? It means, generally, that unemployment should peak later this year, probably in the middle of the 9% to 10% range. Housing prices are probably already bottoming. Commercial real estate prices are, as we've noted, sector dependent (and also geographically dependent, as we'll discuss in later issues). Our forecasts also depend on the notion that domestic credit markets will be functioning off life support by the end of the summer, and reasonably well supported real estate development and investment deals will be funded on financially feasible terms.

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