

# FALCON

REAL ESTATE INVESTMENT COMPANY, LP



*Comprehensive Services for Investors in U.S. Real Estate*

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## The US Real Estate Market Supply/Demand Situation

One of the most fundamental concepts that is applicable to every type of investment — stocks, bonds, commodities or real estate — is that prices are basically determined by the supply/demand relationship for that asset. There are other factors that can affect pricing from time to time, but where a true auction market exists, the relationship between supply and demand is the principal determining factor.

When the credit crisis hit the financial markets of the world in the latter half of 2007 and a severe economic recession followed, it was generally assumed that the US commercial real estate market would be devastated, as it had been 20 years earlier following the savings and loan debacle. A great many distressed assets were expected to flood the market and most of the sources of capital that had supported the extraordinary run-up in real estate prices were expected to disappear. In point of fact, this did begin to happen in 2008 and early 2009, and those who acted quickly and decisively were able to obtain some very high quality properties at very reasonable prices.

However, the situation with respect to both the supply and the demand sides of the US commercial real estate market changed rather quickly. Even though the credit markets remained frozen, within a very short time a tremendous amount of equity capital appeared from both domestic and foreign sources, all of it seeking prime properties in a few select markets. But for a variety of reasons, there was no corresponding increase in supply to meet the increased demand, and as a result prices — particularly in those few select markets including New York, Boston, Washington DC, and San Francisco — moved back up close to the levels seen prior to the onset of the recession.

As we move into the second half of 2010, Falcon Real Estate believes that factors are in place that will lead to some increase in the supply of quality properties coming to market, while demand (as measured by the amount of cash looking for investments) may have peaked. We continue to believe that investors coming into the US commercial real estate market today can find excellent investments as long as they have reasonable and fairly broad investment objectives and are able to act quickly and decisively.

### THE DEMAND SIDE OF THE MARKET

As a result of the credit crisis and the recession, a great deal of pressure built up on US institutional investors, such as pension funds and university endowment funds, to invest in assets that would provide higher return levels. The stock market collapse had devastated these funds and neither corporations nor state governments had sufficient income to contribute to them in order to make up for their losses. In order to fight the recession, the Federal Reserve Board had cut short-term interest rates effectively to zero and long-term rates hovered in the 2% to 4% range. Commercial real estate, with going-in capitalization

rates of 7% to 8%, plus the prospect of inflation protection and some capital appreciation over time, appeared to be a very attractive alternative. Therefore, a great many institutional investors allocated increasing amounts to commercial real estate.

In addition, a large number of private equity funds were formed by groups such as Morgan Stanley and Chicago developer John Buck. Literally billions of dollars were raised from individual and institutional investors anxious to capitalize on the flood of distressed properties that were expected to hit the market. There were a wide variety of investment objectives for these funds, with some intending to buy up defaulted

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mortgages to gain control of good properties, others intending to buy or originate mezzanine debt and others simply looking to buy good properties at bargain prices.

The third major group that came into the market were foreign institutions and individuals. Many sovereign wealth funds, such as ADIA, the Qatar Investment Authority, the Kuwait Investment Authority and the Government of Singapore Investment Corporation made high-profile purchases of US commercial real estate and indicated that they were looking to expand their portfolios.

And finally the Real Estate Investment Trust industry made a dramatic turn around. When the credit crisis first hit, many of the REITs appeared to be on the verge of bankruptcy, with insufficient cash flow to meet their various obligations. But just as private equity funds were able to raise billions of dollars in 2008 and 2009, many REITs, such as SL Green in New York City, went to the stock market and raised very significant amounts of cash, so that instead of being forced to sell properties, they became major purchasers of quality real estate.

The combination of all these factors meant that there was an extraordinary amount of equity capital seeking high-quality commercial real estate in the US. And to compound the problem, most of these groups wanted to focus on only a small number of major US geographical markets.

## **THE SUPPLY SIDE OF THE MARKET**

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Because commercial real estate prices had soared in 2006 and 2007, many owners of real estate decided to sell to take advantage of the high prices. As a result, there was a sufficient supply of properties reaching the market to satisfy the credit-fueled demand that existed at the time. However, when prices collapsed in late 2007 and 2008, so-called discretionary sellers withdrew from the market but, contrary to expectations, distressed sellers were very slow to appear. The ability of distressed property owners to hold on to their assets is due to several factors. First of all, as we have commented in a number of previous newsletters, the basic fundamentals of the commercial real estate market have held up surprisingly well in this recession. Occupancy rates have declined, as have rental rates, of course, but such declines have been relatively mild compared to the collapse in those rates that occurred in the late '80's and early '90's. As a result, many owners are continuing to receive sufficient income to service their mortgage debt. This permits them to continue to hold their property, even though its value may be less than the existing debt, in the hope that the market might improve over time.

At the same time, the banks are being very slow to foreclose on properties with maturing debt. While there are still a great many properties with negative equity positions (one estimate puts the total at close to \$167 billion), the banks are not anxious to take these properties back and recognize the losses that would be involved. So all too frequently the banks use the so-called "pretend and extend" approach to dealing with maturing debt, maintaining the same value of the property on their books, and extending the loan for another two or three years. The special

servicers, who handle mortgages that have been sold into various pools, also have limited incentives to force the sale of distressed assets, particularly since they frequently have investments in those properties and their own investments would be wiped out if they were to force a sale.

Therefore, discretionary sellers are on the sidelines waiting for prices to improve, and distressed sellers are under little or no pressure by the banks or special servicers at the present time so they are able to continue to hold their assets. This results in relatively few quality properties reaching the market. As a result, there is more demand than supply in many geographic markets in the US today.

## **THE FUTURE TRENDS**

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Several things are happening that should, on the one hand, bring more properties to the market and, on the other hand, remove some of the money that has been chasing the relatively few assets that are available. *The Wall Street Journal* recently reported that 19 private-equity funds were unable to find appropriate investments for their portfolios and, as a result, they are returning over \$6 billion dollars to their investors. This will not only take a great deal of money out of the market, but should also act to restrain the formation of any similar funds going forward.

On the supply side, it seems inevitable that the banks and special servicers will begin foreclosing on more properties that are either in default or cannot be re-financed. Both groups will have to become more realistic and recognize their existing losses. As this happens, more properties will begin to appear on the market. This process is taking longer than had originally been anticipated, but Falcon expects that we will see increased offerings of distressed properties later this year and into 2011.

We also expect to see an increase in discretionary sellers. This group has been holding back hoping to see the market rebound and, while there has been some price improvement in some of the major markets, pressures continue to build for discretionary sellers to take action. One of the major considerations is the increased capital gains taxes that result from the expiration of the Bush tax cuts and the enactment of Obama's health care plan. Most investors who have held real estate for any length of time will have taxable capital gains, even at the current lower price level, since they will have written down their cost bases through depreciation.

Therefore, we expect that the amount of money pouring into the commercial real estate market will subside, while there should be a slow uptrend in the number of properties coming to market. As a result, we expect to see a gradual increase in the number of transactions occurring in the US market nationwide during the balance of 2010 and into 2011.

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