

WHY INVEST IN U.S. COMMERCIAL REAL ESTATE WHEN CAPITAL MARKETS ARE IN TURMOIL?

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INTRODUCTION

Assessing real estate market conditions in this time of uncertainty and turbulence is no easy task for real estate managers and investors. Fundamentals that reflect market conditions, like vacancy rates and construction, are clearly solid, albeit no longer stellar. The macro-economic outlook suggests that tenant demand for space will be lackluster for the balance of 2008 and possibly longer, but if an uncertain economic outlook was the only concern, an investor could simply look to acquire properties with minimal lease rollover over the next one to two years of expected economic weakness.

What is complicating the decision-making process is that this is not a “typical” recession, but something more complicated and more uncertain. Treasury rates remain at generational lows while credit spreads are at recession-like wides. Credit availability is constrained and available only to the most credit-worthy with stringent underwriting requirements. While the uncertainties associated with the economic outlook and financial markets’ dislocation might seem to make it a good time to sit tight until there is clear evidence that economic and capital markets conditions have stabilized, such deer-in-the-headlights behavior creates no value for investors. In this white paper, we explain how we as investors understand the current situation and how we identify investment opportunities not despite the turmoil but because of it!



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PRICING MOMENTUM HALTED

Quick profits from high-speed property flipping are no longer a possibility even for the most aggressive buyers in today's market. The pricing momentum that made short-term transactions profitable is over. Today's environment requires a more patient and/or tactically astute investor. The high double-digit returns experienced by core real estate investments during the last few years was unprecedented, and unlikely to be replicated in the near term, if ever. Moreover, the National Council of Real Estate Investment Fiduciaries' ("NCREIF") thirty-year history shows institutional real estate returns distributed around a bond-like average in the 8–9% range. Resetting our expectations for core performance in this range is not only prudent, but essential for identifying realistic opportunities. Value-add and opportunistic returns are expected to revert to their historic norms as well.

A long-term investment horizon coupled with realistic performance expectations for commercial real estate as a whole are the starting points for building strategies that can deliver above-average returns.

RECOGNIZE AND UNDERSTAND HOW DRASTICALLY OUR WORLD HAS CHANGED

The era of easy money that spawned mammoth leveraged buyouts, multi-billion dollar property portfolio acquisitions, and skinny spreads is not long in the past chronologically, but psychologically quite distant. Lenders' and buyers' attitudes about the values, risk, and appropriate spreads of all types of assets, including commercial real estate, have changed dramatically since late 2007. For the commercial real estate market, the steady downward drift of cap rates that characterized the 2002–2006 period came to an end in late 2007 in the aftermath of the subprime residential mortgage crisis. The widening of cap rates and lending constraints imposed by the credit crunch that has accompanied it have, in turn, slowed the pace of commercial real estate transactions drastically.

These factors are visible and concrete as detailed in the paragraphs that follow. While cap rates, loan volumes and spreads make the headlines, behind these indicators is a complicated backdrop of forces that investors need to untangle before opportunities can be identified.

UNDERSTANDING THE NEW ENVIRONMENT: FINANCIAL MARKETS CONDITIONS

In our attempt to untangle the forces roiling financial markets, we have identified three distinct effects contributing to market volatility: *regime shift*, *contagion effect*, and *credit constraints*. The first two are rather arcane, albeit important, concepts while the third is well-known as the "credit crunch."

REGIME SHIFT

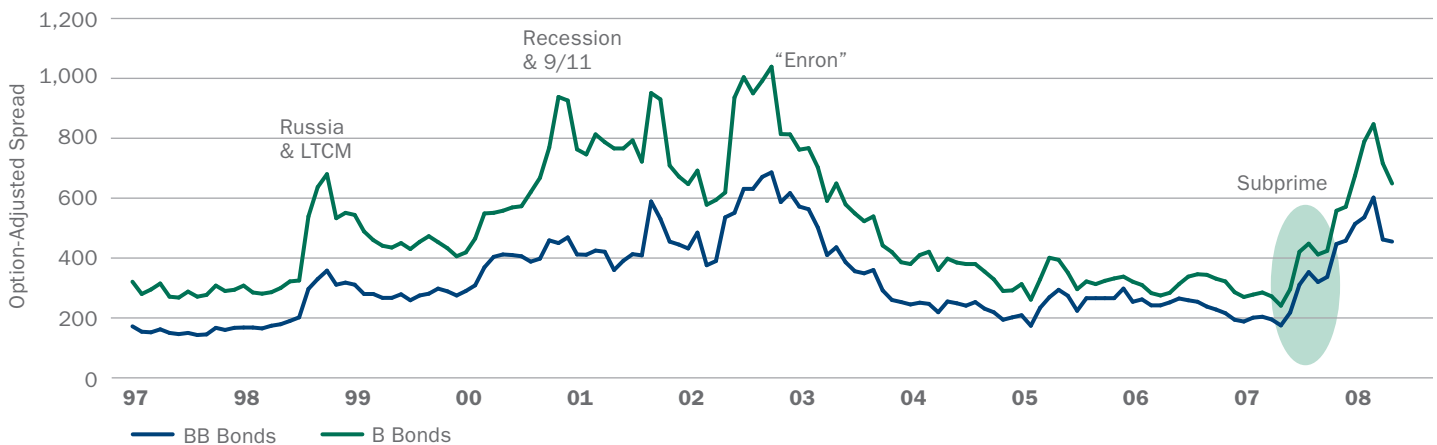
A re-pricing of risk that ultimately permeated all asset types took hold in financial markets in mid-summer 2007. The re-pricing was ignited by losses associated with subprime residential mortgages, but its roots can be traced back to the pattern of the recovery following the last recession. Following the collapse of stock prices in early 2000, domestic and foreign investors sought out safe and relatively high-yielding investments to rebuild and solidify portfolios. Stocks lost favor; fixed income and alternative investments garnered favor. Foreign capital came in search of the comparatively stronger investment opportunities in the United States. The growing trade deficit further contributed to the flood of foreign capital as the trade imbalance left foreigners with excess dollars for investment. U.S. monetary policy was extremely accommodating, bolstering U.S. economic growth. Coupled with hungry capital flows, the stage was set for enormous financial innovation. This produced new instruments and markets that promised to control risk, improve market efficiency, and create investment opportunities. The attributes of these new products combined to compress credit spreads and boost asset prices.

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By late 2006/early 2007, market participants recognized that pricing was becoming increasingly frothy and aggressive. Expectations of a correction were widespread even as more and more aggressive deals were pursued. By the summer of 2007, a series of financial shocks precipitated by losses associated with subprime residential mortgages finally shook the markets into a re-pricing of risk that ultimately permeated all asset types. Such re-pricings have occurred in the past in similar environments and are sometimes called “regime shift” in that they represent a new pricing paradigm. This is illustrated in the circled portion of Exhibit 1, which shows how BB and B corporate spreads spiked by 250–300 basis points, respectively, in just a few short months during the latter half of 2007.

Similar spikes have occurred in the past, such as in 1998 following Russia’s default and the Long Term Capital Management debacle; it too followed a period of very tight spreads and high asset prices. That was followed soon after by the 2001 recession and the “Enron era” corporate scandals that accompanied it; again spreads spiked. After that recession, spreads declined steadily until the mid-2007 regime shift. Credit standards and credit availability have tightened in all markets and credit spreads have widened. Commercial real estate cap rates have widened, though primarily for properties in secondary markets and locations. Commercial property values have slipped, though in large part because of more conservative assumptions contained in property valuations.

EXHIBIT 1: CORPORATE BIG SPREADS



Source: Merrill Lynch via Bloomberg

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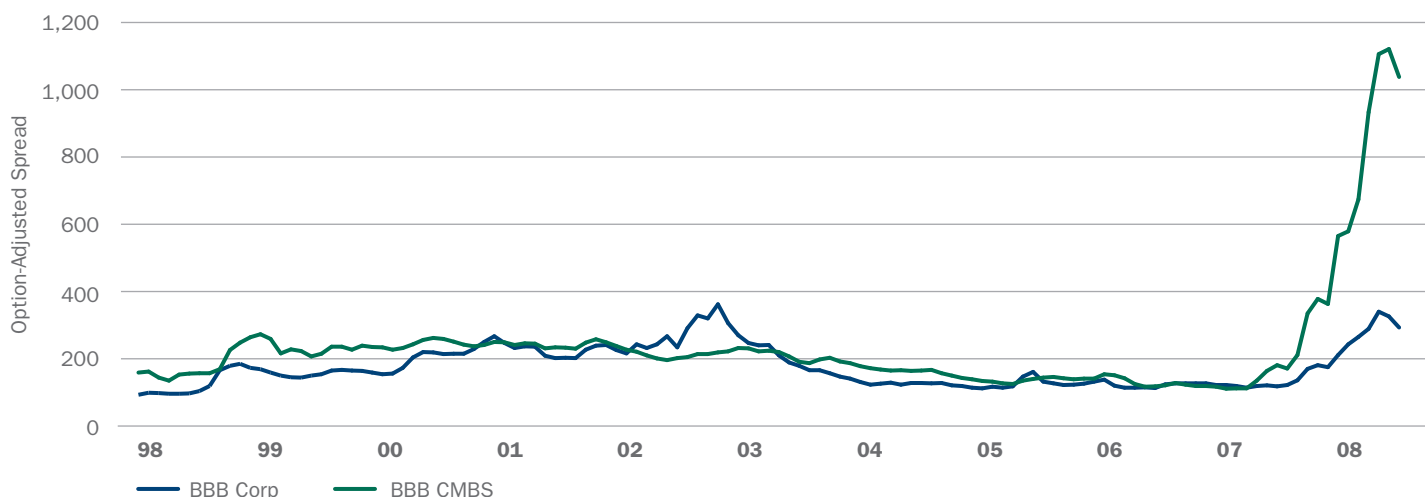
CONTAGION EFFECT

Contagion occurs when a spike in *fundamental risk* affecting one particular asset type spills over to affect pricing of other unrelated asset types with little or no change in their fundamental risks. The *contagion* of recent months involves an irrational paranoia that appears to have emanated from the very real problems affecting subprime residential mortgages, sweeping into all types of structured securities and to a lesser degree into corporate bonds, municipals, and government agencies. The result was explosive spread widening for all types of fixed income investments. Like regime shift, contagion has historic precedents. In 1998, Russia's default and Thailand's currency revaluation produced enormous and excessive pricing reactions across essentially *all* emerging markets. Pricing became unrelated to country fundamentals and was driven by broad-brush emerging market paranoia.

The contagion affecting CMBS has been particularly acute. For example, as shown in Exhibit 2, spreads on BBB CMBS tranches have exploded compared to BBB corporate bonds. This erosion in pricing is not a reflection of real estate fundamentals, which are quite solid as described subsequently. Moreover, CMBS default rates are currently less than 1% as compared with whole loan default rates reaching 18% in the early 1990s when commercial real estate was inundated with excess supply. While a February 2008 Standard & Poor's report notes that there was some deterioration in credit underwriting in 2006–2007 CMBS vintages, the spread widening is so enormous as to imply a historically unprecedented 25–30% default rate (Standard and Poor's, CMBS Quarterly Insights, February 7, 2008 and Commercial Mortgage Alert, February 15, 2008).

On top of the material negative contagion effects on CMBS, a shadow is creeping toward commercial real estate in general as the losses associated with CMBS and similar instruments are referred to as "commercial real estate losses" in the media, which further feeds paranoia.

EXHIBIT 2: BBB SPREADS



Source: Merrill Lynch via Bloomberg

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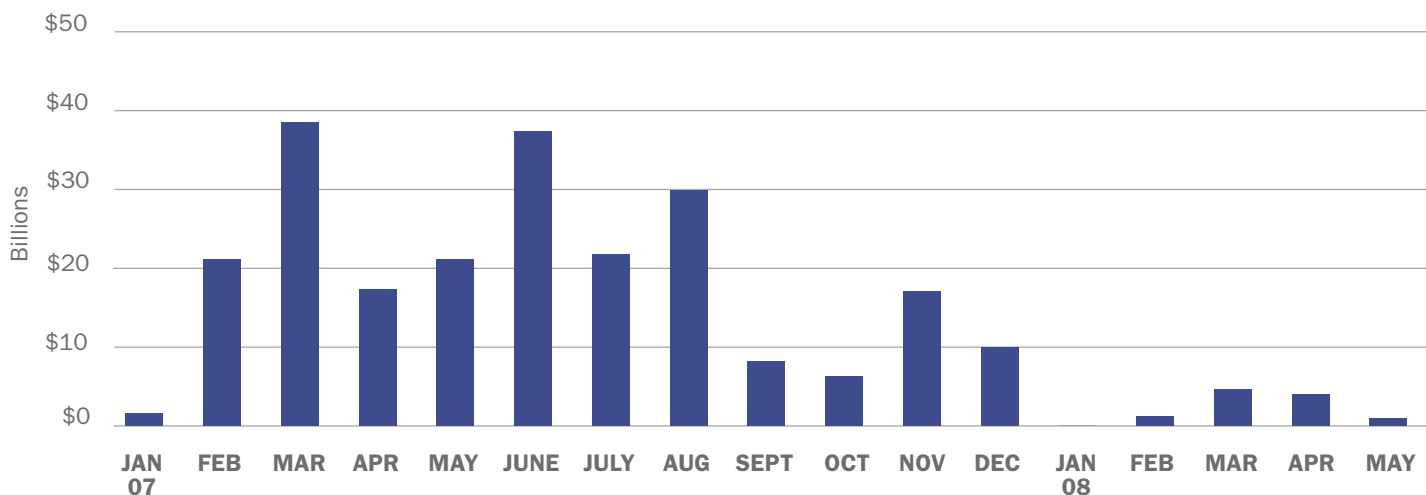
CREDIT CONSTRAINTS

Disruption in the CMBS markets along with tightening underwriting standards and wider credit spreads have zapped credit flows for commercial real estate. The abundant credit environment that prevailed until mid 2007 ended rather abruptly when regime shift and contagion took hold. Lenders pulled back for several reasons including erosion of their capital base stemming from the re-pricing of subprime and related assets as well as the generalized re-pricing of all risky assets. Irrational contagion caused and is causing further losses and straining available reserves. On top of actual losses to date, lenders are dogged by fears of recession, which are likely to result in rising defaults and credit losses in consumer lending portfolios. The Federal Reserve has responded aggressively to the disruption, reducing the Fed Funds rate seven times since September by a total of 325 basis points. The Fed Funds rate is currently 2%, the lowest since November

2004. Flow of Funds data show that the rate cuts, thus far, have had little effect on credit availability as commercial mortgage lending declined 29% during the fourth quarter of 2007 compared with 3Q07 and over 40% from the 2Q07 peak.

Credit from CMBS issuance, in particular, has dropped precipitously, as shown in Exhibit 3 below. While life insurance companies would appear to be in a perfect position to pick up the slack, they too are limited by capital concerns. Life insurance companies are not able to replace the dwindling supply of CMBS issuance with conventional whole loan commercial mortgages. Required capital ratios are significantly higher for conventional mortgages than investment-grade CMBS. Like banks, life insurance companies have no excess reserves to redirect into conventional mortgages, especially with recession looming. Note that CMBS *issuance* amounted to \$250 billion in 2007, which was roughly equivalent to ACLI member *holdings*.

EXHIBIT 3: U.S. CMBS ISSUANCE



Source: Commercial Mortgage Securities Association

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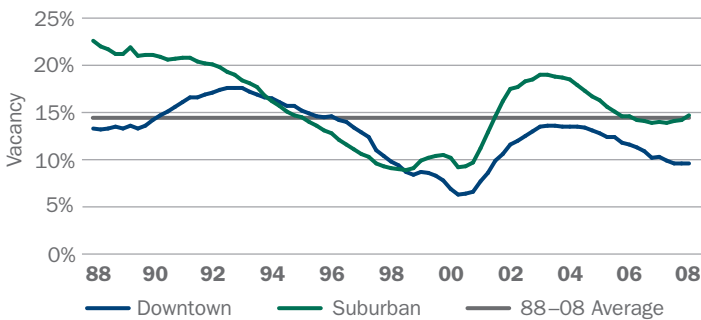
REAL ESTATE FUNDAMENTALS BASICALLY SOLID BUT PAST PEAK

In contrast to the turmoil in financial markets, commercial real estate fundamentals are holding up rather well. This conclusion is most clearly summarized by variables such as vacancy rates, rent growth and net operating income (“NOI”), as well as construction and absorption. By way of quick summary:

All four major property types (apartment, industrial, office and retail) had vacancy rates near or below their long-term averages as of the first quarter of 2008. We show office and warehouse vacancy rates in Exhibits 4A and 4B to illustrate.

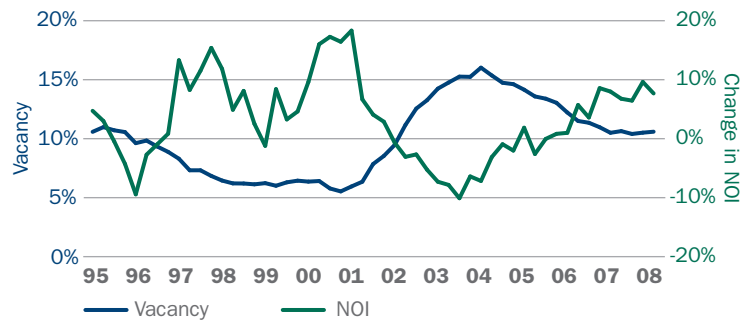
The tightening vacancy rates in recent years nurtured growth in rents and NOI as illustrated in Exhibits 5A and 5B for office and warehouse properties owned by members of NCREIF.

EXHIBIT 4A: OFFICE VACANCIES (NATIONAL AVERAGE)



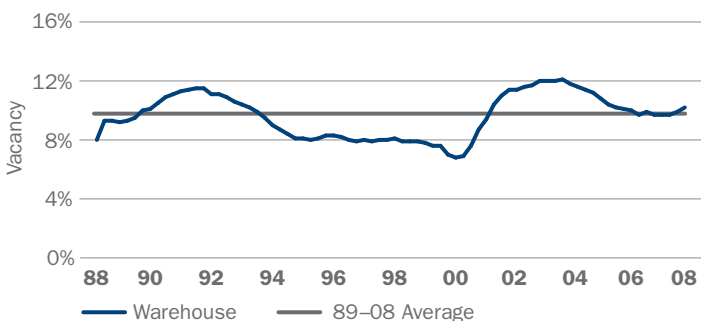
Source: Torto Wheaton Research

EXHIBIT 5A: OFFICE VACANCY AND NOI



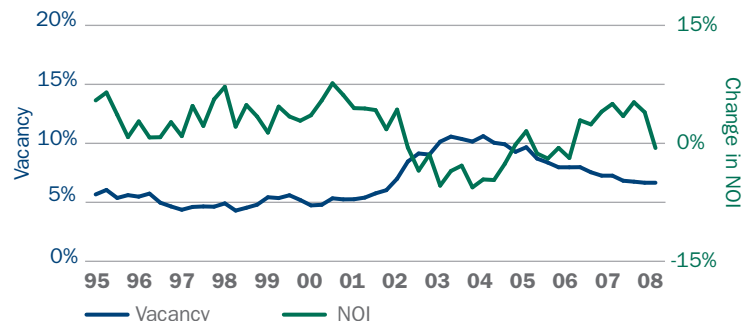
Source: NCREIF

EXHIBIT 4B: WAREHOUSE VACANCIES (NATIONAL AVERAGE)



Source: Torto Wheaton Research

EXHIBIT 5B: WAREHOUSE VACANCY AND NOI



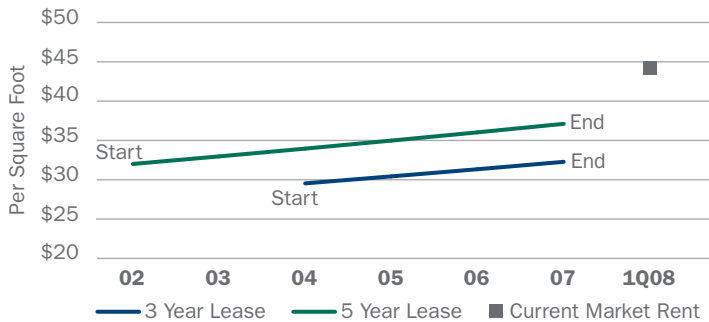
Source: NCREIF

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The weak economic environment will put a damper on rent growth, but we expect NOI growth to remain healthy, recession or not. One reason for this is that there will be opportunities to renew or release expiring leases at higher rents. As shown in Exhibits 6A and 6B, average asking rents for downtown Class A office space are on average 35% above maturing leases signed three years ago and 20% above those signed five years ago. Similarly, average warehouse rents are currently 7% and 1%, on average, above estimated rents for maturing three- and five-year leases.

Office and warehouse construction in 2008 will be below peak construction in prior cycles, as shown in Exhibits 7A and 7B. Looking ahead, we expect that construction of all property types will decline over the next several years as there are already indications that the credit crunch, escalating construction materials costs, and uncertainty about the macro-economic outlook are curtailing construction. Given lead times needed for obtaining project approvals and typical construction timetables, it may take considerable time before construction picks up significantly again.

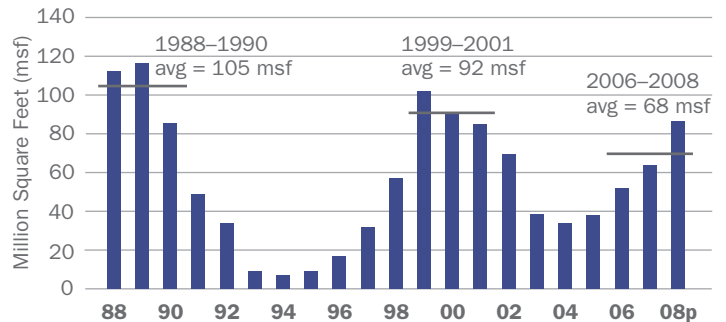
EXHIBIT 6A: AVERAGE DOWNTOWN CLASS A OFFICE RENTS



Source: Torto Wheaton Research and TIAA-CREF

Note: Rent increases of 3% per year are assumed per typical lease terms.

EXHIBIT 7A: OFFICE CONSTRUCTION



Source: Torto Wheaton Research

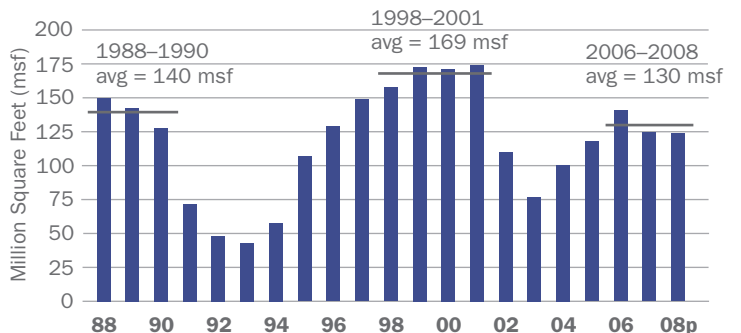
EXHIBIT 6B: AVERAGE WAREHOUSE RENTS



Source: Torto Wheaton Research and TIAA-CREF

Note: Rent increases of 3% per year are assumed per typical lease terms.

EXHIBIT 7B: WAREHOUSE CONSTRUCTION



Source: Torto Wheaton Research

WHY INVEST IN U.S. COMMERCIAL REAL ESTATE WHEN CAPITAL MARKETS ARE IN TURMOIL?

Weak U.S. economic growth prospects are a negative force in commercial real estate markets. The majority of economists believe that the U.S. economy is in recession. As shown in Exhibit 8A, on average, forecasters expect GDP growth of less than 1% during the second quarter of 2008 and tepid growth for the remainder of the year. The weakness of the economy is reflected in recent employment reports. From January through June, 438,000 jobs disappeared with more cuts expected as banks and investment banks cope with the losses associated with subprime residential mortgages investments and other structured securities. Spillover into related professional and business service providers has begun. These cuts, coupled with the continuing erosion of the U.S. manufacturing base and declines in construction employment, portend very anemic job growth at best over the balance of 2008. Historical employment growth is shown in Exhibit 8B.

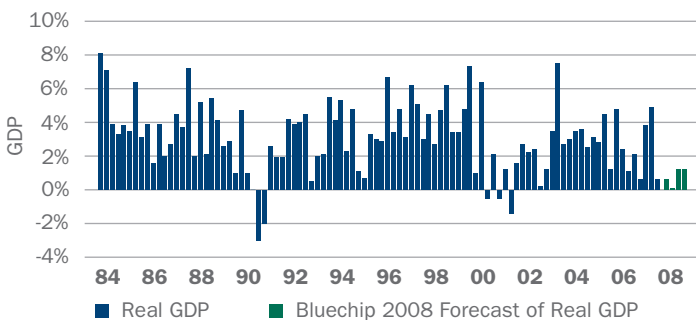
These fundamental factors in the aggregate support a conclusion that U.S. property markets are facing uncertain

economic prospects in 2008, yet atop a relatively solid foundation. However, market conditions and economic prospects vary by market, with some metro areas having lower vacancies and less construction than others. While most have passed their cycle peaks and a few have experienced some property value erosion, fundamentals are far and away better than at the onset of both the 1990–92 and 2001 recessions when the real estate pipeline was stuffed with excess supply.

OPPORTUNITY AMID ADVERSITY

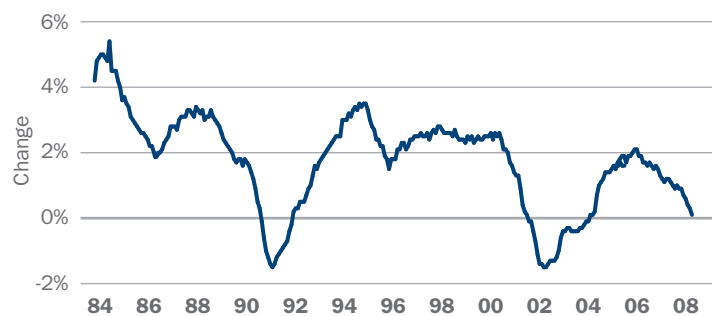
With capital markets in turmoil and credit availability constrained, cash is king. While potential returns are becoming commensurate with associated risk, only the most deep-pocketed and creative investors are in a position to benefit. With this unique combination of solid real estate fundamentals and turbulent capital markets, opportunities are emerging on two fronts: via the re-pricing of risk and the credit crunch.

EXHIBIT 8A: U.S. REAL GDP



Source: Bureau of Economic Analysis via Bloomberg

EXHIBIT 8B: U.S. EMPLOYMENT GROWTH



Source: Bureau of Labor Statistics

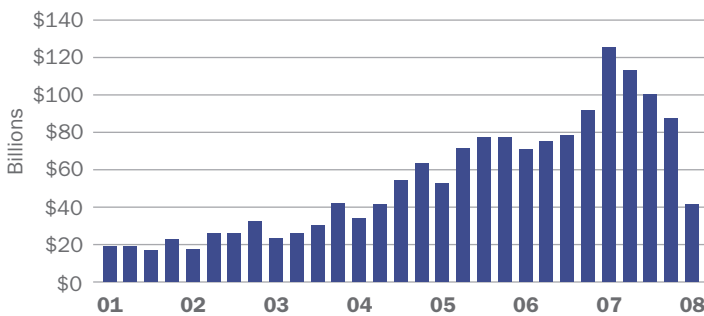
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RISK REPRICING OPPORTUNITIES

Reflecting the change in market psychology that is the essence of the re-pricing of risk, investors have become more discerning and cautious about values of all types of assets during an economic slowdown, including commercial real estate. As a result, cap rates have widened, though only modestly and most visibly for properties in secondary markets and locations. There is little evidence that cap rates for top tier properties have risen, in large part because of very limited transaction activity. At the very least, cap rates for top tier properties are no longer compressing, and may have inched up. These two trends—minimal sales activity and stabilizing to slightly rising cap rates—are shown in Exhibits 9A and 9B. Equally important, the disappearance of leveraged buyers is contributing to a more measured and rational bidding process. Fewer numbers of potential buyers is also offering some negotiating leverage to investors who are still buying, especially cash buyers with solid reputations for execution.

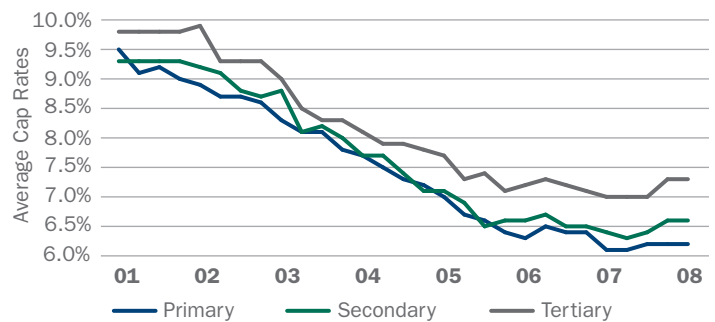
This shift toward more discerning pricing is particularly important for value-add investors because prices are beginning to reflect value-add opportunity and risks more accurately than has been true in quite a long time. Of course, reaping such opportunities requires that investors have the experience and expertise to separate promising opportunities from dead ends.

EXHIBIT 9A: QUARTERLY TRANSACTIONAL VOLUME



Source: Real Capital Analytics

EXHIBIT 9B: AVERAGE CAP RATES



Source: Real Capital Analytics

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CREDIT CRUNCH OPPORTUNITIES

The effect of the credit crunch is not only evident in the dramatic slowdown in sales activity, but in lenders' attitudes about the risk associated with commercial real estate investment and development. Survey responses of senior lending officers summarized in Exhibit 10 below suggest that credit availability is tighter now than during the real estate credit crunch of 1989–92, and tighter than in 2001, when markets were awash in space.

The likely result is that there will probably be very little additional construction other than what is already underway. Construction could plummet for several years as it did in 1993–1995 when office construction averaged a mere 8 million square feet, or 0.3% of U.S. stock. Looking ahead, minimal construction coupled with the consensus Blue Chip Economic Forecast of a modest recovery accelerating over the course of 2009 paints a very compelling picture from a supply/demand perspective. Core assets with minimal near-term rollover should benefit from limited new construction and economic recovery in 2009 and beyond. Investment returns would benefit more so if properties can be acquired at higher cap rates over the next 6–18 months, which is a possibility if owners become more anxious and prospective buyers become scarcer.

A second potential opportunity involves value-add investments, especially those involving significant property repositioning over a 12–18 month period. Redevelopment undertaken while the U.S. economy is in transition could be an optimal use of this time, and more importantly, repositioned properties may become a more important source of high-quality space in the near term if construction dwindles. Ground-up development, pursued on a highly selective basis in top markets, could be another way to make productive use of the lull in economic activity and the capital markets upheaval. The timetable and risks associated with ground-up construction would obviously be greater, but a 24–36 month planning/permitting/construction/lease-up period could prove to be optimal.

Another potential opportunity associated with the credit crunch involves real estate owned by non-real estate businesses. Companies finding it difficult to secure credit in today's environment may see sale-leasebacks of company-owned property as a simpler and less expensive alternative to a typical corporate loan with restrictive covenants and other onerous terms. Sale-leasebacks can also free up capital without adding to a company's debt load. Such transactions require real estate investors with both cash and the expertise to assess industry and business risk as well as potential upside and downside risk of single-tenant property, such as the costs associated with converting a single-tenant building to multi-tenant use. This will probably not be a major source of business, but could nonetheless provide opportunities on a limited basis.

EXHIBIT 10: U.S. CREDIT AVAILABILITY, COMMERCIAL REAL ESTATE

	NET % OF RESPONDENTS REPORTING	
	TIGHTENING STANDARDS FOR COMM RE LOANS	STRONGER DEMAND FOR COMM RE LOANS
2Q 1990	69.4%	Not Asked
3Q 1990	61.7%	Not Asked
3Q 2001	42.6%	-30.9%
4Q 2001	44.7%	-51.8%
1Q 2008	80.3%	-46.5%
2Q 2008	78.6%	-37.5%

Source: The Federal Reserve Board

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Beyond these opportunities, capital markets conditions are producing “broken deals” that involve properties of all style types negotiated before the regime shift. For some, acquisition financing has disappeared leaving buyers stranded and sellers in limbo. When sellers have time constraints, price concessions are sometimes available to cash buyers with solid reputations for execution. Similar opportunities are emerging as short-term, real estate-related debt reaches maturity. With the punchbowl of easy money now off the table, leveraged owners are finding themselves in a bind. Under-capitalized owners and *credit wrecks*, which include developers of languishing projects and opportunistic investors with highly-leveraged portfolios and maturing short-term debt, may provide opportunities for all-cash buyers with real estate savvy to profit.

CLOSING COMMENTS

Untangling the disparate features of the current commercial real estate market environment is a necessary first step before attractive investment opportunities can be identified. In this report, we attempt such an untangling by tracing the separate features of the macro-economic weakening, the “regime shift” in investment risk pricing, the contagion in risk aversion, and the credit crunch. Attractive commercial real estate opportunities in such an environment require long-horizon patience, available cash, expertise in all investment styles including core, value-add and opportunistic new construction, as well as access to extensive market intelligence and deal flow. Deal selection can be further facilitated by preparatory analysis of geographic markets to identify attractive versus unattractive metropolitan area locations.

Opportunities include reaping the benefit of core real estate purchased at 2008 prices in markets with extremely limited flows of new construction. Acquiring and repositioning value-add properties in this environment as well as selective ground-up development are also attractive. In a slightly different vein, providing sale-leasebacks of owner-occupied corporate properties is an avenue for benefiting from the generalized credit crunch. Similarly, stepping into broken deals to acquire attractive real estate at distressed prices is another possibility that might emerge from the credit crunch.

As stated at the outset, this is no “typical” recession, but what recession is typical? Recessions begin and end due to a unique combination of factors and events. Yet, there are always opportunities amidst adversity. In this paper, we untangle the threads that created this uncertain environment and, in doing so, identify ways in which investors with cash, foresight and experience can potentially benefit.

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