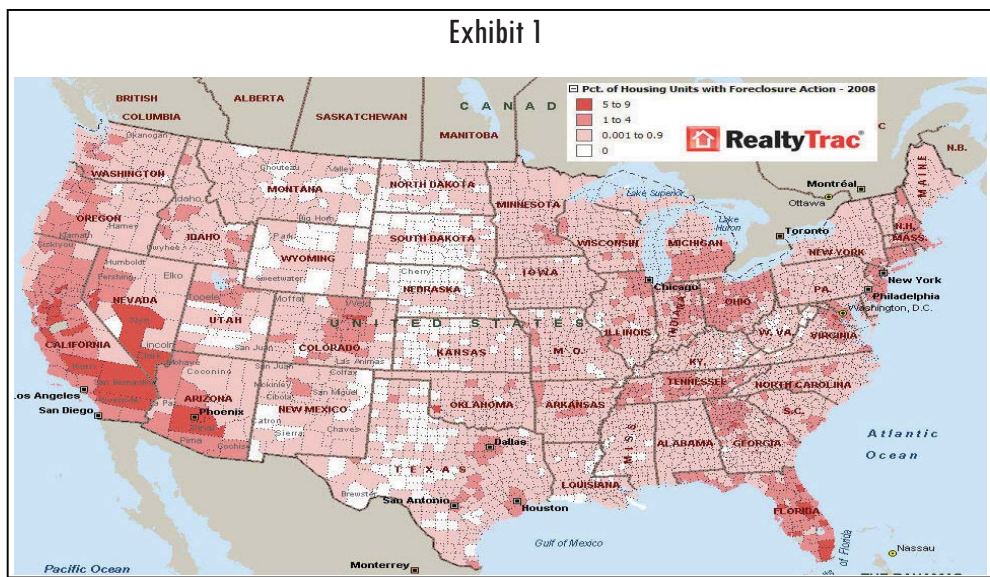


❖ How Bad Will the Downturn Be?

The recession of 2008 is well into its second year as of 1st Quarter 2009 and it looks to be one of the longest downturns ever. Given that real estate houses our economy, the implications for the U.S. real estate market going forward are not good. With respect to the economy, the signs are ominous: unemployment at 7.6% (approx. 12.7% if you include part-timers who cannot find full time employment), job losses of over 2.6 million in 2008 and another 500,000 plus in 2009; a revamped government intervention program, which may ultimately cost over \$1 trillion; federal guarantee and investment programs totaling over \$8.5 trillion; home values down 12% in January alone; 3.2 million foreclosure filings in 2008 on 2.3 million properties; the CMBS and other capital markets still in disarray; and commercial real estate values down 11.2% in 2008,¹ poised to follow NAREIT down further. See Exhibit 1.

The last time the commercial real estate sector saw such sizable declines was in the 1990-1991 recession. Such dramatic declines continued despite the broader economy rebounding in the middle of 1991. The NCREIF Property Index declined 32.3% from the peak in 1990 until the trough in 1995. The span of six years of depreciation suppressed total returns to negative and low single digits until 1994, where the total return was 6.5%. This massive decline followed a 12 year run of appreciation in the index totaling 60.4% in increased value from the index base year of 1978.



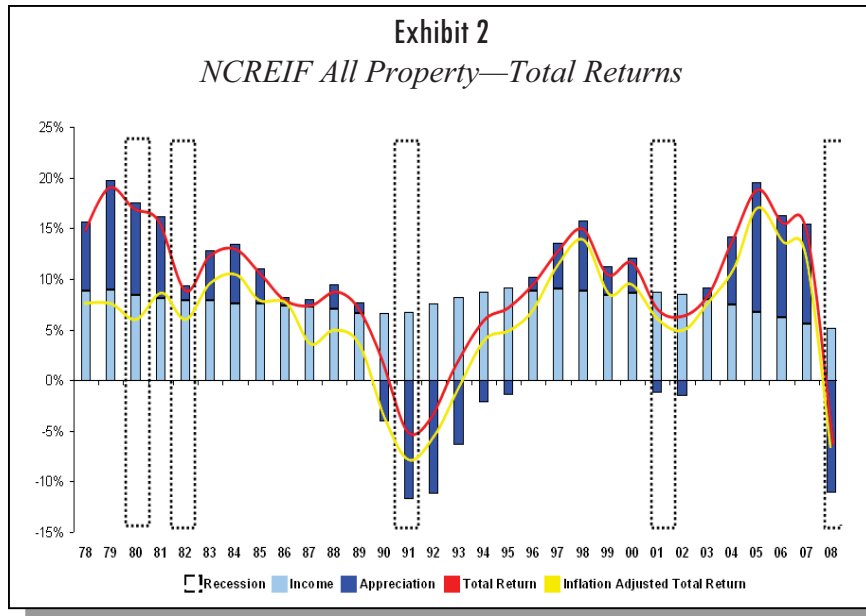
❖ Michael Humphrey

Managing Principal

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¹NCREIF



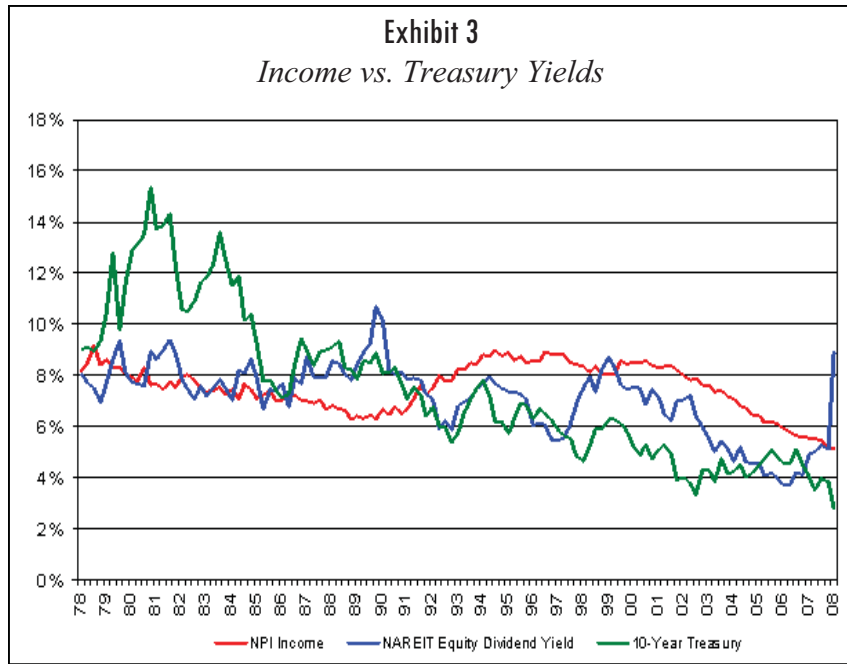
The following expansionary period (1996-2000) resulted in five years of appreciation and a total of 20.5%. The short decline in values in 2001-2002, following 9/11, resulted in a decrease of 2.8% before the most recent run-up, fueled by easy credit and loose lending standards, drove values higher by 47.2% in a period of five years.

As of 4th Quarter 2008, the NCREIF Property Index one-year appreciation return was down 11.2%, the first year of declines during this recession. During the 1990-1991 recession, property values decreased significantly in the first three years of the downturn; the current downturn has started off with greater value decline in the first year. (See Exhibit 2.) Although history may not be an exact indicator of returns, it certainly suggests that a prolonged downturn of three-to-five years is likely given the severity of this economic decline. To expect a quick rebound in values would be uncharacteristic of previous downturns. In light of the 32% peak to trough decline in the early 90s, there is little reason to suggest that the 11.2% decline thus far is approaching a bottom in valuations. Value declines of another 20% plus may occur. In contrast to the recent decline in REITs, -61.2%, from peak to trough, this decline likely has further to go.

The run-up in values before the 1990-1995

decline was due in part to the rampant inflation in the late 70s and early 80s in conjunction with an over-supply of product. Contrary to the current downturn, the run-up was not spurred by any untamed inflation, but rather a low-interest, low inflationary period. The amount of value attributable to the frothy credit markets is uncertain, but the downside result of the current illiquidity is sure to be significant. Additionally, the size of the government intervention may bring inflation back into the picture at some point. This could make real estate a desirable inflationary hedge once again, but only if a reasonable supply-demand balance exists permitting property owners to increase rents during the inflationary period. The last downturn was also due to over-investment creating over-supply, whereas this downturn is markedly different with contracting demand due to deteriorating economic conditions being the major factor. When the rebound does come, this supply/demand equation will likely impact the timing of such a recovery.

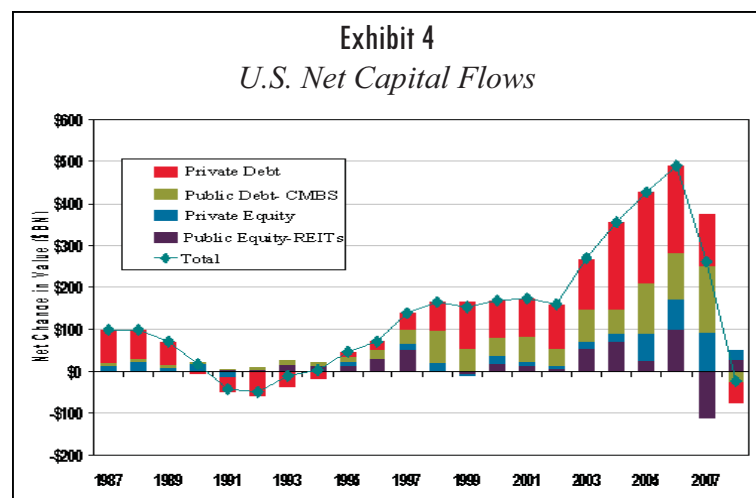
As you will see in Exhibit 3 (next page,) preceding the 1990-1991 recession the 10-year Treasury hovered in the 8-9% range. Rates began to fall in late 1990, and 1991-1993 rates plummeted to approx. 5.4%. Likewise in this current recession, the 10-year Treasury has spiraled downward from 5.1% in mid 2007 to



2.2% in 4Q08. Real estate values remained in a slump for six years, despite the decline in long-term rates. The 10-year Treasury has been at historic lows for years as real estate values have risen. Today, as values retreat, the 10-year Treasury remains at historic lows reflecting the level of market fear and a flight to quality by investors. Notably, REIT yields have increased to upwards of 8-9%, increasing the spread over treasuries to 5.0% to 6.0%.

As shown in Exhibit 4, U.S. net capital flows into commercial real estate, including private debt, public debt (CMBS), private equity, and public equity (REITs), rose sharply in recent

years favorably impacting real estate values. Starting in the latter half of 2007 capital flows began to reverse; and in 2008, net capital flows turned negative (-\$23 billion), for the first time since 1993. The significance lies in the fact that the last time total capital flows were negative, from 1991-1993, real estate returns experienced downturns of corresponding degrees. Almost a four-year period of negative or flat net capital flows ensued before any substantial rebound. Of that total, private debt inflows were negative for five years from 1990-1994. Today, private debt is off from \$123 billion in 2007 to -\$50 billion in 2008. Looking forward, the downturn in the real



estate capital markets may continue for a number of years resulting in a multi-year decline in asset values comparable to that of prior downturns (1990s).

Going Forward

An historical view of the 1990s downturn in real estate may provide a reasonable indicator as to the severity of the current downturn and its impact on real estate. While there are differences between the current period and the 1990s downturn (e.g., oversupply of commercial space

in the 1990s), there are similarities that appear to make the comparison reasonable. In any event, the current market illiquidity and deteriorating economic conditions will continue to adversely affect real estate. While the federal government intervention to stem such deterioration is aggressive, the long term impact on the economy and real estate values is uncertain. Going forward, given the value declines experienced in other asset classes and in public real estate, it appears that it is likely that private U.S. real estate values may decline another 20-30% depending on the degree of the economic downturn.

Michael has his B.A. (summa cum laude) in Economics from Wittenberg University; and his J.D. from Columbia University Law School, where he was a Stone Scholar.