



**Commercial Real Estate:  
What Have We Learned So Far ...  
And Where Do We Go From Here?**

Virginia Commonwealth University  
October 13, 2009

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**I. WHAT HAVE WE LEARNED SO FAR?**

- A. Models Are a Necessary But Not a Sufficient Tool
- B. The Sources of Market Risk Have Changed
- C. Liquidity is Paramount
- D. You Can't Cram for a Crisis

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## II. WHERE DO WE GO FROM HERE?

- A. Prices Will Not Return to Levels of a Few Years Ago:  
Assets Were Never Worth That In the First Place
- B. Cap Rates Should Reflect Risk-Adjusted Pricing
- C. This Is Going To Take a While ... Measured in Years,  
Not Months or Quarters



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## I. WHAT HAVE WE LEARNED SO FAR?

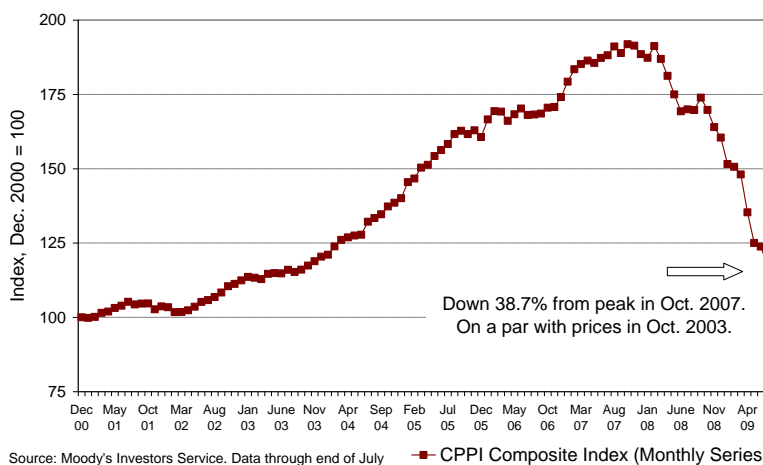


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## Prices for CRE Have Dropped Like the Proverbial Stone

### Moody's/REAL Composite Commercial Property Price Index (CPPI)



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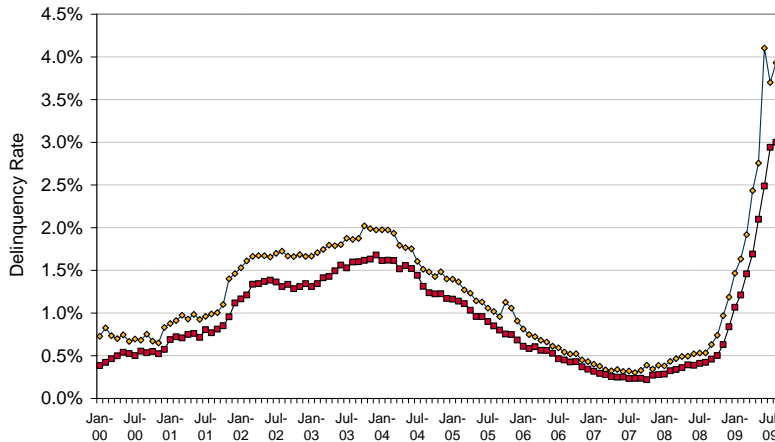
## THE SOURCES OF MARKET RISK HAVE CHANGED

- We now have political or policy risk to a degree and of a character not previously seen in commercial real estate
- As more power over the financial system shifts to global *political* capitals, market dynamics may shift *from* economic fundamentals *to* technical factors or political considerations
  - In one scenario, quants may find themselves getting traded for policy wonks
- Some assets are now being priced based on *technical factors* rather than the underlying fundamentals.  
Example: the CMBS market

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**CMBS Delinquency Mirrors Data on Prices, Values and Returns**

**CMBS: 30+ and 60+ Day Delinquency**



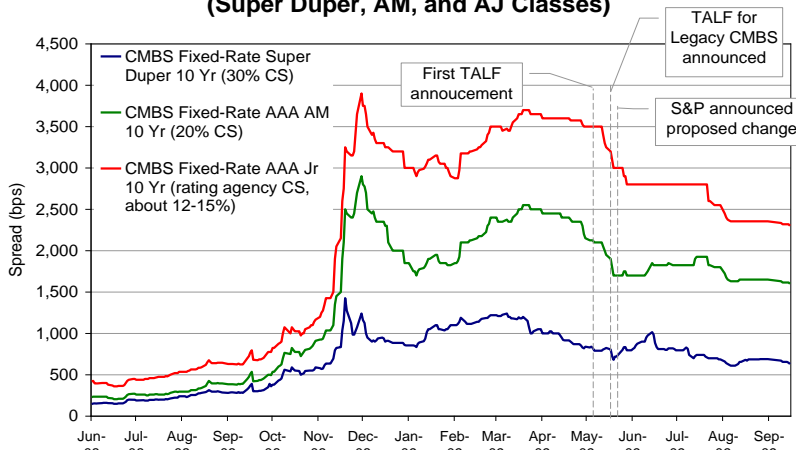
Source: Wells Fargo. Data through August 2009.

—◇— 30+ Delinq (%)    —■— 60+ Delinq (%)

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**CMBS Technicals Are Not In Sync With Fundamentals**

**Historical Cash CMBS AAA Spreads (Super Duper, AM, and AJ Classes)**



Source: Barclay's Capital. Data through Sept. 16, 2009.

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## LIQUIDITY IS PARAMOUNT

- ❑ Liquidity is really the lifeblood of a modern economy
- ❑ Liquidity was not a fact of life but a special condition
- ❑ When markets are disrupted, the value of liquidity rises
- ❑ The centrality of liquidity has three elements:
  - Arbitrage
  - Time Horizon
  - Cash Generation
- ❑ During a liquidity crisis, a “diversified” portfolio of illiquid assets may not behave as expected

*Diversification works - until it doesn't*

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## YOU CAN'T CRAM FOR A CRISIS

- ❑ Corollary: Just being smart isn't enough
- ❑ Effective risk management is and has to be an expensive long-term investment
  - Support from the very top of the organization essential
  - Subject matter expertise is critical
  - A data base of portfolio holdings and characteristics facilitates fast response to the unexpected
- ❑ How do you manage a Black Swan?
- ❑ A team and efficient information infrastructure in place will enable a response to swans of any color or stripe

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## II. WHERE DO WE GO FROM HERE?



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### PRICES: THEY WERE NEVER WORTH THAT IN THE FIRST PLACE

- What goes down doesn't necessarily go up
- Prices can stay flat at the bottom for a long time
- When they recover, prices/values do not *have* to return to previous levels
- Think "phantom values" ... many dot-com's were never really worth what some people thought they were worth
- Previous valuations that were predicated on excessive leverage should not be expected to return



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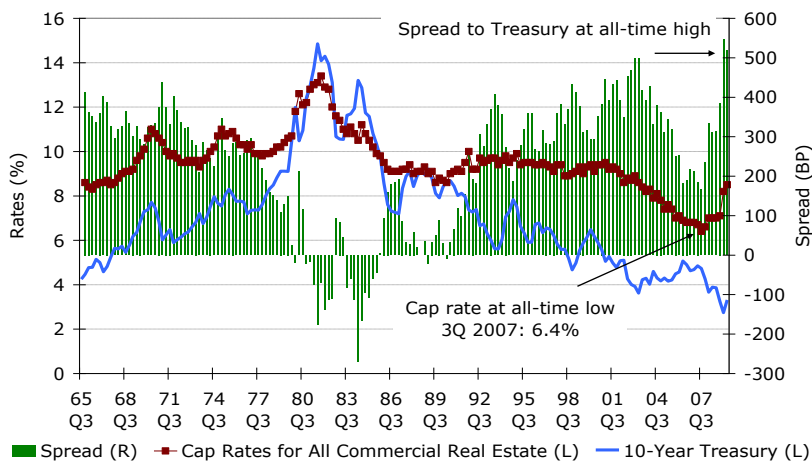
## CAP RATES SHOULD REFLECT RISK-ADJUSTED PRICING

- ❑ Cap rates of 6%-ish probably do not equate to appropriate risk-adjusted pricing
- ❑ Even returning to a long-term average bakes in a 40%-45% loss in value
- ❑ On the other hand, cap rates and cap rate spreads could over-shoot

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## Wider Cap Rates & Cap Rate Spreads Bespeak a Large Risk Premium for CRE

### Spread Between Cap Rates and 10-Year Treasuries



Sources: American Council of Life Insurers (ACLI); Federal Reserve. Data through 2Q 2009.

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### Higher Cap Rates + Drop in Income Could Push Values Down More

#### CHANGE IN VALUE WITH CHANGES IN CAP RATES AND NET OPERATING INCOMES (NOI)

NOTE: Values already are down 38.7% from the peak in Oct., 2007.

	2007 Level ↓		Current (2Q 2009) ↓	Long-Term Average ↓		
Change in Cap Rate →	6.50%	7.50%	8.50%	9.50%	10.50%	11.5%
Change in NOI ↓						
Cash Flow Flat at 2007 Level						
% Change from Base	Baseline	-13.3%	-23.5%	-31.6%	-38.1%	-43.5%
Cash Flow Down 10%						
% Change from Base	-10.0%	-22.0%	-31.2%	-38.4%	-44.3%	-49.1%
Cash Flow Down 20%						
% Change from Base	-20.0%	-30.7%	-38.8%	-45.3%	-50.5%	-54.8%

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### THIS IS GOING TO TAKE A WHILE

- ❑ “A while” is measured in years, not months or quarters
- ❑ Banks, with approximately 50% of CRE debt outstanding, are unwilling - or unable - to re-price dodgy assets
- ❑ CMBS still hold 20-25% of CRE debt
- ❑ While securitization markets might come back, they will likely look different ... assuming that some of the prevailing tensions and issues are resolved

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### CMBS Investor Conflict

#### Impact on Different CMBS Bond Holders With Various Workout Strategies

Senior Bonds	Lower Tranches	Interest Only (IO) Strips
<b>Scenario #1. Loan goes into special servicing. Special servicer forecloses on the loan and sells at market level (assume a loss of approximately 40%).</b>		
Senior bonds get principal back sooner than originally expected and therefore have a higher yield (assuming that bonds had been bought at a discount)	Lower tranches are potentially blown out, i.e., they do not receive any return of principal and no further interest for their originally expected term	Lose value partially or totally, as interest cash flow to the IO is shut off completely or partially

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### CMBS Investor Conflict

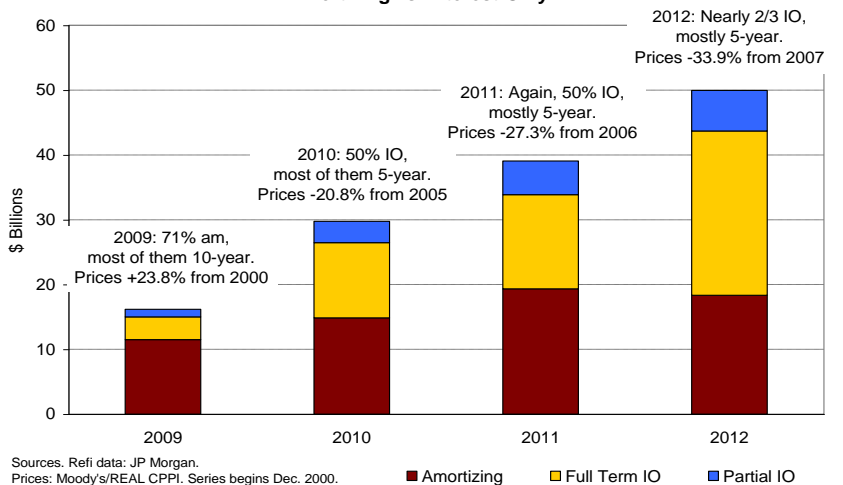
#### Impact on Different CMBS Bond Holders With Various Workout Strategies

Senior Bonds	Lower Tranches	Interest Only (IO) Strips
<b>Scenario #2. Loan goes into special servicing. Special servicer works it out and extends the loan, with no change in terms other than maturity.</b>		
Senior bonds survive but don't get the proceeds from default at original balloon. Extension hurts as yields are lower than otherwise would have been if there had been no default or if foreclosed loan had been sold	Lower tranches survive and continue to receive interest payments	IO's extend, making them more valuable

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### ... And Then There Are Those Pesky Refinances ...

**Distribution of Fixed-Rate CMBS Loans To Be Refinanced:  
Amortizing vs. Interest-Only**



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### RECAP


So far, we have learned - or re-learned - many lessons from the last year or so, about:

- The limitations of models
- New sources of market risk
- The importance of liquidity
- You can't cram for a crisis

And where we go from here:

- Prices probably have not fully stabilized
- Cap rates could create further pressure on prices
- All-in, it is going to take a while for the re-pricing to work through the system of all players, debt and equity

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??? QUESTIONS ???



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