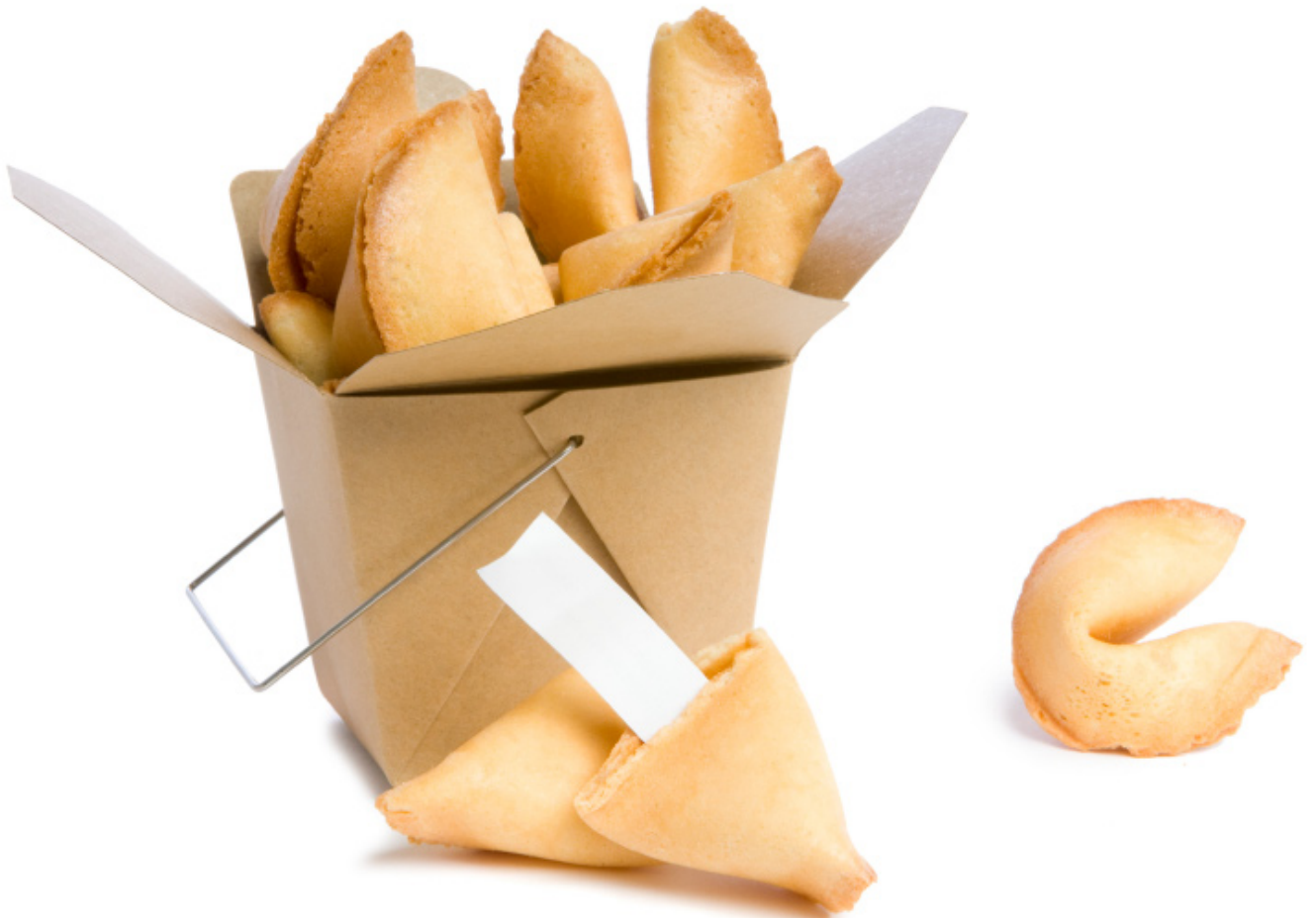


## 2009 Industry Outlook: Real Estate Challenging Times, Emerging Opportunities





# Real Estate



Following several years of spectacular returns for the commercial real estate industry, global credit problems that began in the U.S. residential subprime market have spilled over into the commercial debt markets, resulting in suppressed transaction volumes and limited access to financing. While real estate remains a relatively good investment option, especially in light of the recent volatility of competing asset classes such as stocks and bonds, the real estate sector itself faces several challenges in 2009 that are symptomatic of a general economy in distress.

In terms of magnitude, commercial real estate's biggest concern is debt maturity. Quite a few companies have debt coming due in 2009; however, it is becoming increasingly difficult to access credit to refinance that debt. If companies can't secure financing, they can't operate. Even those commercial real estate firms which have debt maturity into 2010 and 2011 and are looking to purchase distressed assets to build-out their portfolios are finding it difficult to obtain financing. The end result: Nothing is selling and business is grinding to a halt.

Unfortunately, options are limited for those real estate companies whose debts mature in 2009. Until funds from the Emergency Economic Stabilization Act begin to flow through to borrowers, the real estate industry will continue to have little access to debt. Companies could try to renegotiate terms with their bank, but that is unlikely. Alternatively, companies could institute cost-cutting

measures and conserve cash to accrue the funds they need to pay down debt. In fact, cash preservation will be an important tactic for all commercial real estate companies in the coming year – even those with healthy balance sheets – because lines of credit could be pulled without warning.

In another disturbing development, the worsening economy is beginning to have a domino effect on U.S. commercial real estate fundamentals. Increasing numbers of retailers – confronted with liquidity issues, reduced consumer spending and weak credit conditions – are being forced into bankruptcy, leaving the country dotted with empty storefronts. Unless these properties are well-located, real estate companies may have trouble filling vacancies. Similarly, the meltdown of the financial services sector is reducing demand for office space in cities such as New York City and others with a high concentration of financial services companies, and could spread to other markets.

The current slowdown in commercial real estate activity is not about equity – there are companies that have plenty of that. When financing at reasonable rates becomes more readily available the floodgates should open because real estate continues to attract domestic and international investors. Two actions, in particular, could help get transactions moving again: First, if property sellers are willing to provide seller financing, they could counter banks' reluctance to lend money. Second, if landlords whose tenants are facing bankruptcy are willing to temporarily restructure their lease agreements, it could keep those retailers in business and head-off the need to find replacement tenants in a very difficult environment.

Although the search for financing will be top-of-mind for real estate executives in 2009, two other issues, globalization and a changing legislative and reporting environment, also will require attention:

## **Globalization**

Globalization is a two-way street for the commercial real estate industry, and traffic is expected to flow both ways in 2009. Investment capital will continue to enter the U.S., particularly as Sovereign Wealth Funds (SWFs) and other private investors take advantage of relatively inexpensive U.S. real estate opportunities resulting from the credit

crunch and the dollar's low value against some other currencies. However, the SWF funding stream may not be as strong in 2009 as in years past due to the widening global recession. Cash-rich U.S. real estate companies, in turn, are likely to continue expanding their international investments in places such as China, India, Russia and Brazil, although some companies are refocusing attention on domestic properties and portfolios because there are considerable U.S.-based opportunities emerging that carry less risk. One trend that is expected to gain momentum in 2009: both U.S. and foreign investors are flocking to major cities such as New York, Los Angeles, Seattle and Atlanta in search of trophy assets.

#### Changing legislative and reporting environment

Real estate is very much a tax-driven industry, and U.S. policy changes that could emerge from the newly elected Democratic administration and Congressional majority may significantly impact the real estate sector in 2009 and beyond. Chief among these are a potential increase in the capital gains rate from 15 to 20 percent, and a redefinition of what counts as capital gains versus ordinary income. This could negatively impact the relative attractiveness of real estate as an investment class.

In the area of reporting and governance, commercial real estate executives should start paying increased attention to the mandatory transition to International Financial Reporting Standards (IFRS), which is proposed to start for fiscal years ending on or after December 15, 2014. To date, the real estate sector has been taking a wait-and-see approach to the topic, but developments over the last year have shifted the discussion from the abstract and distant to the concrete and near-term.

According to the Deloitte publication *IFRS in Real Estate: More Than Just Accounting & Reporting*, characteristics of the commercial real estate industry make it a prime candidate for early IFRS conversion:

- **Real estate is global:** Major Real Estate Investment Trusts (REITs), real estate private equity firms, real estate owners and operators, and corporate real estate divisions often have operations and assets that span countries and continents.

- **Real estate is capital-intensive:** Major initiatives require significant capital. Accounting and financial reporting provide a vital link between real estate companies and their capital providers.
- **Real estate is competitive:** In a challenging economy and a highly competitive market, real estate companies are continually looking for ways to stay ahead of their rivals.

In mid-2008, the American Institute of Certified Public Accountants announced that it considered a three-to-five-year timeline to be reasonable for transition to IFRS.<sup>1</sup> Real estate companies that begin their IFRS preparations now will be better able to avoid obstacles and extract additional benefits from the process. Specifically, an accelerated IFRS conversion can help companies spread out their costs, get a jump on competitors, secure scarce talent before it vanishes, improve processes and systems, and integrate with other initiatives, such as an Enterprise Resource Planning (ERP) system upgrade or a merger or acquisition. Most important, early planning can circumvent the fire-drill atmosphere that characterizes most last-minute projects.<sup>2</sup>

#### Returns should remain relatively attractive

Overall, the outlook for commercial real estate in 2009 is neutral to slightly negative. Private real estate returns are expected to remain relatively attractive, although lower than in recent years. And while fundamentals remain relatively strong in certain markets, the economy is curtailing overall growth and increasing cap rates. Public REITs are struggling to rebound after a negative year in terms of investment performance and are trading at prices well below net asset values (NAV). Also, there is growing concern about commercial mortgage-backed securities (CMBS), most of which will mature in 2010-2012. If there is no market for these securities, the impact on the sector could be extremely negative.

As they wait for financing (and deals) to flow again, commercial real estate investors can take comfort in the fact that the sector is not as overbuilt relative to previous economic downturns or to the housing market, and that real estate continues as a relatively attractive investment option, both at home and abroad.

1 Ibid  
2 Ibid

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