PUBLIC AGENDA ITEM - #19a

19a. Review and Discussion of Real Estate Market

August 25, 2009

BACKGROUND:

In order to highlight potential opportunities and pitfalls for Employees Retirement System of Texas ("ERS") real estate portfolio investments for fiscal year 2010 and beyond, ERS investment staff asked RV Kuhns & Associates (RVK), ERS' real estate investments consultant, to provide an overview of current real estate market conditions, both domestically and internationally.

The commercial real estate market worldwide has suffered over the past 18-24 months, which provides ERS opportunity to selectively take advantage of the market distress. ERS should be selective about investment, particularly paying close attention to the amount of leverage employed in any particular strategy. RVK believes that the current real estate market downturn may be more prolonged than many real estate investors care to admit. While commercial real estate pricing may find some equilibrium, this does not imply valuations will return to their 2007 heights in the short-to-medium term. Instead, investors should brace for a protracted period of income comprising the vast majority of investor returns going forward, in contrast to the 2003-2007 period. Lower-risk opportunities in unlevered first mortgage origination and secondary debt purchases provide a return profile only available in leveraged equity positions 18-24 months ago. Additionally, selective income-producing equity investment on a low-leverage or no-leverage basis should be attractive. Finally, many international markets may be appealing venues for capital appreciation, as they are likely to have fewer structural impediments for investors than developed markets, e.g., commercial mortgage-backed securities debt maturations. However, international real estate entails significant risk, e.g., currency, legal, which must be scrupulously examined before investment.

The following is RV Kuhn's overview of real estate markets.

Market Overview:

Commercial Real Estate Debt Financing and Opportunistic Buyers "Waiting" – Spillover from the residential real estate market collapse into the commercial real estate markets over the last year has significantly influenced both domestic and international investor sentiment and implementation of real estate investment strategies going forward. Largely, investors are awaiting further property depression in hopes to "pick the bottom" before committing to further substantial real estate investment. While opportunistic buyers remain cautious about the current real estate market, many are poised to enter or re-enter the market given more compelling real estate valuations presenting themselves than available 18-24 months ago. Beyond the negative sentiment in mainstream and financial press reports, strategic buyers are starting to identify value in the real estate market, looking to capitalize on the investment opportunities created as a result of the market's lack of liquidity.

However, the impact of these opportunistic buyers "waiting on the sidelines" has been overstated, at least in the short-term. The inaccessibility of bank financing has limited the extent to which investors can lever their real estate investment positions. During the most recent market frenzy, many investors levered their positions 80 percent or more on a loan-to-value basis. Those days are over, and a more rational leverage environment is taking hold. Currently, there is significant fear among lenders about the value of underlying real estate collateral. Thus, debt financing is particularly expensive to procure beyond approximately the 60 percent loan-to-value level, if it is available at all.

The "Denominator Effect" Meets the "Numerator Effect" – Stringent credit conditions and difficultly accessing capital will limit pricing in both residential and commercial real estate markets for some time. While this has provided significant opportunities to invest in debt and distressed assets, many investors have become over-allocated to the private real estate market due to the "denominator effect." Simply stated, many institutional investors have stopped committing capital to real estate because their real estate asset allocation targets have been breached. As a result, many private equity real estate funds have been unable to fundraise. This should provide opportunity for longer-term investors such as ERS who are under-allocated to private real estate to purchase assets for long-term return potential, as there are fewer large investors able or willing to commit to purchase assets.

As real estate market values fall for these "denominator effect" investors and non-real estate asset market values increase from their market lows, the "numerator effect" is likely to take hold. Because private real estate assets are valued on an appraisal basis, sometimes only annually, this delayed "numerator effect" of value writedowns may allow certain investors to commit capital to real estate once their asset allocation ranges allow them to do so. However, given the recent pain experienced by these investors in the commercial real estate market, it is quite likely that at least some of these institutional investors will "hold tight" and not commit to new funds for the next several years, looking for signs of equilibrium and appreciation in real estate valuations.

Lack of Available Financing Creates Opportunity for Investors With Capital – Financing covenants continue to be much more restrictive, the cost of borrowing remains high, and banks' willingness to lend continues to be low in light of declining real estate asset prices. Suppressed transaction volumes and limited access to financing has shifted focus to income rather than capital appreciation in order to hit target returns. While there are continuing challenges near term, the sharp decline in capital flows into the real estate asset class may create a competitive advantage to those investors with capital to deploy in the current environment. While distressed assets will provide attractive pricing, there are challenges to taking advantage of the opportunities. Growth prospects will be more carefully evaluated with regard to sustainability of return streams in a low-leverage or even no-leverage environment. To this end, the real estate market continues to suffer from capitalization rate expansion.

Global Real Estate Market Themes:

Real Estate Securities Rebounding In Contrast to Private Real Estate – The global economy has deflated severely over the last year, although there have been some encouraging signs of potential rebound in the last few months. While global stock markets have rallied from their March 2009 lows, and global real estate securities have participated in this rally, private real estate has not

enjoyed this same rebound. Whether the real estate securities rebound was simply a byproduct of the overall equity market rebound, or a signal of an impending private market real estate rebound, is a matter of considerable debate. Currently, however, real estate investors in North America and Western Europe are experiencing severe credit-related challenges, leading to increased distressed sales of premier properties. The pace of distressed selling is likely to increase in the latter part of 2009 and into 2010 as more real estate debt matures.

Emerging Market Real Estate Following Developed Markets – Through much of 2008, emerging market real estate had been holding up better than that of developed markets, but that is no longer the case. Eastern European economies have suffered tremendously, with Latvia being a notable example of severe distress. Moreover, economies that are commodity or natural resource-driven, such as Brazil and Russia, have suffered. These economies are very cyclically-oriented and should be approached with caution. Asian economies, while not doing well on an absolute basis, are holding up on a relative basis. Chinese economic stimulus appears to be having a positive effect on the Asian region as a whole. In contrast to developed markets such as North America and Western Europe, emerging market real estate generally was not levered using commercial mortgage-backed securities or other syndication strategies, potentially allowing for a quicker rebound compared to developed markets constantly fighting against the tide of large-scale debt maturities.

Real Estate Investing Secularly Becoming Mainstream – While there is short-term distress in real estate markets, institutional investors worldwide such as pension plans and sovereign wealth funds have been increasing allocations to real estate, infrastructure, and timber over the long term. The cited reasons include portfolio diversification, inflation hedging, and alpha-generation. Moreover, global real estate securities legislation has enabled significant liquidity, potentially increasing long-term appreciation prospects for early investors in global real estate securities. However, the recent fluctuations in both public and private real estate markets have affected the risk tolerance of many investors, particularly many recent entrants into real estate. Sovereign wealth funds, which had been major purchasers of real estate towards the market top in 2007, are now slowing their pace of investment. While they remain cautious toward current market valuations, sovereign wealth funds are starting to identify the benefits of procurement of real estate in developed markets today, including the opportunity to circumvent potential currency depreciation and to take advantage of capital appreciation upon recovery of the market.

New Themes Developing in Global Real Estate Investment – During the recent real estate boom of 2003-2007, institutions directly invested in buyouts of public real estate investment trusts and real estate operating companies in order to take advantage of disparities between public and private market pricing. As valuations continued to increase, sophisticated institutional investors focused on ever-increasingly risky strategies, including bridge loans to speculative purchasers, developers, and real estate operating companies, in order to generate returns. Other secular, and more sustainable, themes that have developed are investments in urban redevelopment, green real estate, and infrastructure. While many of these themes have subsided over the last 12 months, new themes focusing on eventual rebound from distressed pricing have developed. These themes include taking advantage of first mortgage debt origination, mezzanine debt acquisition and origination, land banking, and single-family residential purchases.

Developed Market Opportunities:

Capital Market Effects on Real Estate Investment – Capitalization rates have increased and are likely to continue to increase as private real estate pricing reverts to historical trend. In the past, low capitalization rates were driven by property demand that outstripped supply, fed by heavy borrowing due to low interest rates. Lenders are more risk-averse than in the recent past, with lower loan-to-value limits and much stronger debt covenants, e.g., debt service coverage ratios, placed on nearly all investors. Tighter credit terms may restrict overcapacity and assist to stabilize a balance between supply and demand. Although the cost of debt is substantially higher than at the real estate market top of 2007, the cost of debt is likely to stabilize over the longer-term as new lenders come into the market. It is likely that income, rather than capital appreciation, will drive the vast majority of returns going forward. While this is a change from the recent past, it is a reversion to historical trend.

Core Real Estate Assets Are Still Expensive – Core real estate assets, e.g., Class A office buildings, new multifamily structures, are still expensive compared to historic trend, although the most recent transactions in the core space show pricing to have decreased significantly. There is continued concern about high pricing in both primary and secondary cities. Primary cities such as London, New York, and Tokyo have suffered as much or even more than most secondary cities, as pricing reached unprecedented levels during the 2006-2007 period. Moreover, there is concern of a secular downturn in global financial centers, as many highly-paid financial services professionals have lost their employment, and the likelihood of finding similar high-paying jobs is small. However, regional-specific investment opportunities providing compelling value propositions have materialized over the downturn. Distressed selling and the need to deleverage investments could potentially create an attractive pricing environment in the next several years as sellers face an increasingly crowded market with sale offerings far exceeding closings.

Domestic Overbuilding in Condominiums and Retail, Less in Office and Industrial – Condominium and speculative retail developments are the most significantly overbuilt sectors in the United States. Opportunistic investors had focused on markets such as Las Vegas, Miami, Phoenix, and the California Inland Empire for fast appreciation returns. These markets have suffered the most over the last two years, as real estate prices have fallen in excess of 50 percent in many of these markets. Office and industrial development has been relatively modest, but the economic slowdown nevertheless will hurt returns in these areas. The credit turmoil, fluctuating commodity costs, and moderating demand will keep construction in check. Demand has suffered among virtually all businesses, as the impact on the financial services and homebuilding sectors is spreading across the economy.

In April 2009, the U.S. office vacancy rate was 15.2 percent, up from lows in January 2007 of 10.8 percent. Average asking rents are now falling in most markets, particularly in New York City and other markets hampered by distress in the financial services sector. The greatest deterioration in office fundamentals has been in markets with greatest exposure to the collapse of the mortgage and financial services industries, e.g., Florida, Orange County, Phoenix, New York City. There is a significant bid-ask spread between sellers and buyers, which will ultimately lead to lower pricing for office properties.

Multifamily Caution – From 2003 to 2007, fundamentals in the multifamily sector strengthened as a result of continued job and income growth, limited new supply, and affordability constraints of home ownership. Most markets are beginning to experience moderating rental rate growth due to decreased demand and new supply in certain markets, especially where there has been excessive condominium development. Of particular concern is the possibility that government-sponsored entity, i.e., Fannie Mae and Freddie Mac, lending that has supported multifamily asset pricing might contract as a consequence of their effective nationalization in September 2008. While the income return streams from multifamily assets tend to be the least volatile among the major property types, a potential lack of lending in the multifamily space might affect exit liquidity. Caution regarding multifamily assets is warranted.

Western European Credit Bust – Western Europe has suffered as much, if not more, than the United States from the speculative frenzy in real estate and the subsequent credit contraction and bust. The United Kingdom, Ireland, Norway, and Iceland were most negatively affected. France, Germany, Spain, and Italy are rapidly catching up. The Scandinavian countries are performing relatively better, but are also suffering from recent Russian economic concerns. The lack of coordinated central bank intervention may hamper economic and real estate market recovery. Current programs to deal with market instability in Europe have not firmly taken hold.

Japanese Concerns – In Japan, the traditional "yield spread" play has disappeared on high-quality assets with maximum loan-to-values available in the 60 percent range compared to 90 percent+ during the 2003-2007 period. Pricing on core Japanese assets has already fallen 30-35 percent from its 2008 heights. Cyclical downturn in Japanese economy may make traditional value-add investment difficult. Many companies are still holding non-essential real estate assets that they wish to get off of their balance sheets. There are still opportunities to acquire assets at attractive discounts, either through direct sales or through sale/leaseback mechanisms, although exits should be evaluated carefully. Managers in the recent past have indicated the growth in the Japanese REIT (J-REIT) market would be a natural outlet for their property stock. With the recent retrenchment in J-REIT pricing, RVK is concerned about the attractiveness of this outlet.

Capitalize on Overleveraged Situations – Core and value-added strategies with significant current income components, including first mortgage and mezzanine debt origination and acquisitions, are attractive in the current market. Opportunistic strategies in land, office portfolios, and institutional asset spin-offs are attractive if real estate managers can properly underwrite the risks and hold for the very long-term. Attractive opportunities exist to capitalize on distressed loans, particularly in light of the $700 million TARP program and European bank distress, e.g., Fortis, Hypo Real Estate. Buyers are experiencing a surge in real estate secondary opportunities and are looking to take advantage and purchase fund interests at significant discounts. Some of the best risk-adjusted returns can be obtained by investing in distressed debt, by acquiring "hung" loans at significant discounts or by refinancing distressed borrowers**.** However, most managers are unable to properly evaluate commercial mortgage backed securities ("CMBS") for potential investment as a proxy for real estate, and these opportunities should be avoided in lieu of direct whole loans collateralized by real estate.

<u>Emerging Market Conditions:</u>

Secular Reforms Creating Better Environment for Institutional Investment – Political and economic reforms are a creating better environment for foreign direct investment over the long-term in many emerging markets. Governments have recognized that investment in real estate and infrastructure is crucial to continued economic growth. Additionally, local developers have sought strategic partnerships to tap global capital markets. While emerging economies, as a whole, are less dependent upon exports to developed markets than in the past, they still suffer from global economic fluctuations. The recent global contraction has not spared emerging markets.

Asian Markets Helped By Chinese Stimulus – Despite some manager claims up until late 2008 to the contrary, Asia has not "decoupled" from the rest of the world. Asian economies are suffering from the credit crisis and developed market economic slowdown. Over the long term, growth is driven significantly by increased spending power, low-cost workforces, e.g., manufacturing in China and Vietnam, information technology in India and Thailand. Urbanization will continue in these countries over the next 15-30 years, providing opportunities to meet this demand, *albeit with cyclicality*. Currently, export-oriented economies like Singapore and South Korea are suffering significantly.

In China, there is concern that pricing in Beijing and Shanghai is overdone. Institutional capital is targeting residential development in second-tier cities, retail establishments, and industrial properties. Comparisons suggest that residential Shanghai and Beijing pricing approached approximately 50 percent of that of New York City, while secondary cities were at 10-15 percent of such levels. There exists an oversupply of housing in many Tier 1 cities although Tier 2 cities are still significantly undersupplied. Although recent government monetary easing has helped, pricing in Tier 1 cities nevertheless has fallen 20 percent from their 2008 heights. Generally, Chinese real estate investment may not be as attractive as other Asian nations with a more stable supply-demand balance.

Eastern European Market Malaise – Eastern European and Russian real estate capital flows have substantially retrenched. However, other secular factors will likely impact Eastern European and Russian investment over the short-to-medium term. Russia's invasion of Georgia has cooled interest in all Russian assets, including real estate, and has heightened the risk premium associated with investing in the country. Moreover, recognition that Russia is still highly dependent upon the status of the commodity markets has hampered capital inflows. Most of the Eastern European economies are highly dependent on Russian economic growth. Finally, concern about the lack of rule of law in Russia has severely limited investment interest. Lending has dried up in these markets, available only at much lower loan-to-values than the recent past and with generally less-favorable terms and covenants.

Latin America Better Positioned than Many Emerging Economies – Latin America has held relatively firm amid the recent global economic turmoil. Stronger internal demand, lower inflation, and reduced foreign debt have helped decrease the sensitivity to the U.S. and to other developed markets than during past slowdowns. Returns have not been as impaired in Latin America as in other emerging markets. Real estate capital flows to Latin America continue to build and are focused predominantly on Mexico and Brazil. While Argentina, Chile, and Colombia are gaining

attention, they still lack a notable institutional presence. As governments have been more responsible spenders, sovereign debt ratings in many of these countries have improved.

Capital markets are developing and becoming more robust with improved access to commercial and residential mortgage financing. On April 30, 2008, Brazil's sovereign debt was upgraded to BBB-, an investment grade, which provides affirmation of the thesis and provides further impetus for foreign direct investment. Brazil, Mexico, and other Latin American markets are still commodity-sensitive. Pronounced decreases in commodity prices may have a cyclical impact, although these economies continue to diversify.

The percentage of the populations that are entering their prime spending and household formation years is similar to that of the United States during the 1970s. The existing real estate stock is outdated and unsuitable for modern user needs. There are significant residential deficits as the populations enter prime household formation years. Retail formats are going through a structural shift to more western formats, and office buildings need to be built to meet multinational tenant needs, e.g., larger floorplates, air conditioning, high-speed elevators. The risk/reward tradeoffs available for investments in Brazil and Chile are attractive. We are less enthusiastic about Mexico, given its significant ties to US economic growth patterns.

Severe Shortage of High Quality Institutional Assets Provides Opportunity – A limited supply of high quality institutional-grade assets, as well as high demand by multinational corporations and affluent local populations, had driven up prices of these assets through mid-2008, although the global credit crisis has affected pricing in these markets in 2009. Middle-market residential, industrial parks, and warehouse distribution centers all provide attractive long-term investment opportunities, as global economic growth is likely to outpace that of the United States over the long term. However, lax legal systems make finding reputable local managers and developers crucial. The higher fees charged by many investment managers focused on emerging markets compared to developed market investment managers are worth the price in expertise.

This agenda item is presented for discussion purposes only.

STAFF RECOMMENDATION:

No action is required on the agenda item.