



# Quarterly NEWS

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by Brian J. Friedman, CFA

## Will Deteriorating Commercial Real Estate Cause Financial Crisis Aftershocks?

Some investors are jittery because they see mounting problems in the commercial real estate market and can identify parallels with the early, but neglected, clues that emanated from the residential mortgage markets. We believe that commercial real estate fundamentals are poor and deteriorating, but we do not believe commercial real estate woes will cause a repeat of the 2008 financial crisis. We also do not believe that the current fundamentals make commercial real estate an attractive investment.

### The early stages of the residential mortgage crisis

By way of analogy, the recent financial crisis may be viewed as a financial earthquake approaching 9 on the Richter Scale. With hindsight we now know that low interest rates and rising home prices encouraged banks to overextend credit. During the boom years the banks' gamble on weaker borrowers seemed to pay off as the delinquency rate (delinquencies are the sum of loans 30, 60 and 90 days past due) on subprime loans fell to a historic low of 10.3% in 2004. Delinquencies on subprime adjustable rate mortgages (ARMs) were even lower, reaching 9.8% in 2004 as adjustable interest rates were considerably lower than fixed rates at that time.

The first, largely undetected, tremors started in 2006 as the Federal Reserve raised interest rates to 5.25%, pushing subprime ARM delinquencies to 14.4%. The initial tremors appeared to be a localized affair, but their intensity grew as delinquencies mounted, reaching 20.0% by December 2007, 24.2% by December 2008 and 28.2% at present.

The intensifying quake toppled its first structures in the summer of 2007. As mortgage bonds fell in value, investors refused to refinance short-term loans to mortgage underwriters. In a desperate scramble for cash, mortgage dealers were forced to prematurely dump bonds onto an already saturated market. As investors and dealers realized the severity of the problem the mortgage bond market shut down.

The resulting liquidity crunch in August 2007 caused a financial earthquake that measured 5 or 6 on the Richter Scale. According to the Richter definition, a quake of this magnitude can cause damage to poorly constructed buildings, but well designed buildings typically sustain only slight damage. The Federal Reserve intervened to provide credit to the banking system and cut interest rates. This temporarily calmed the markets since the delinquency rate on prime mortgages was only 2.57% in the summer of 2007, slightly higher than the low of 2.22% in 2004. The tremors caused by subprime mortgages once again appeared to be contained within a small segment of the financial system.

It did not take long, however, for new tremors to shake the financial system and the economy. Eventually delinquencies on prime loans also increased, reaching 6.84% as of September 2009. Prime ARMs were even worse. After reaching a low of 2.1% in early 2005, delinquencies on Prime ARMs rose to 3.4% in December 2006, 5.5% by December 2007, 9.7% by December 2008 and 12.4% currently.



IMS ECO GNP AMHMS ECO GNP  
2529<sup>3</sup> 457<sup>3</sup> 555B<sup>1</sup> 2529<sup>3</sup> 457<sup>3</sup> 55

With a time lag, delinquencies eventually turned into foreclosures. Foreclosures increased from fewer than 50,000 per month in 2004 to in excess of 300,000 per month in 2009. While home mortgage delinquencies and foreclosures remain high, the problem appears to be peaking. Home prices are stabilizing and foreclosures are no longer increasing rapidly (although they will remain at this elevated pace well into 2010). Perhaps most importantly for the housing market, layoffs are diminishing thereby placing less income pressure on homeowners.

### **Housing is stabilizing, but what about commercial real estate?**

Although the major earthquake seems to be over, many investors are worried about aftershocks. Observers point to the eerie similarities between the early months of the home mortgage crisis and the current situation in the commercial real estate market.

A recent study based on FDIC data by the consulting firm Real Estate Econometrics shows that the national default rate on commercial real estate loans rose from 2.9% to 3.4% in the first three quarters of 2009. They expect fourth quarter data to indicate a default rate in excess of 4.0%. The majority of current defaults are on loans originated in 2006 and 2007 with most of this debt maturing in 2011 and 2012. A maturation “spike” that may be difficult to refinance in the same manner that adjustable rate mortgages were difficult to refinance in the residential real estate market.

To keep things in perspective it is important to remember that residential mortgages in the United States amount to \$14 trillion while commercial real estate debt is a much smaller \$3.5 trillion. Of this \$3.5 trillion, the greatest risk of default comes from the \$700 billion pooled into securities similar to residential mortgage backed securities. In comparison to residential real estate, close to all (i.e., \$14 trillion) residential mortgages are securitized and securitized loans were the epicenter of the financial earthquake.

### **What about the economic fundamentals of commercial real estate investments?**

To gain greater insight into the status of commercial real estate investments we analyzed publicly traded real estate stocks known as Real Estate Investment Trusts or REITs. While REITs differ in some significant respects from privately owned real estate, they nonetheless offer important clues about the economic fundamentals of U.S. property markets.

Over the past 10 years the market value of REITs in the United States increased from \$90 billion to approximately \$200 billion. There are more than 130 publicly traded REITs invested in a variety of property types including office buildings, retail shopping centers, apartment buildings, hotels, industrial properties, etc. REITs do not pay income taxes at the corporate level if they maintain at least 75% of their assets in real estate; derive at least 75% of their gross income from rents or interest income from mortgages on real property and distribute at least 90% of their taxable income to shareholders in the form of dividends. Essentially REITs are “pass through” vehicles that allow shareholders to own income producing properties in a liquid security.

REIT share prices collapsed during the credit crisis, falling 77% from peak to trough. Investors were concerned that lenders could force many REITs into bankruptcy rather than refinance their loans when they came due. REIT share prices recovered somewhat as the panic environment eased, gaining 123% from their lows, but share prices remain approximately 50% below the highs of early 2007.

Surprisingly, rental income for office, industrial and apartment REITs was relatively flat in 2009 despite the poor economy, but fundamentals are deteriorating as we enter 2010. Regional malls and retail shopping centers were harder hit with rents falling -10% over the past year. Hotels experienced the worst deterioration among publicly traded REITs, as revenue dropped an average -15%.



Although office rents are currently flat, as more leases come up for renewal NAREIT (the REIT trade association) estimates that cash flows from REIT owned office buildings will decline -18% in 2010. Retail shopping centers and regional malls could see further cash flow deterioration of -20%. Apartment REIT cash flows could fall -17% and hotel cash flow a further -10%.

Even though REIT share prices are well below their highs, REITs are probably still not an attractive investment. As can be seen in **Table 1**, dividend yields on REIT stocks are very low. Yields on office and retail REITs are only 3.7% and 2.7% respectively. Cash yields are even lower since many REITs paid their dividends in stock to protect their balance sheets. These yields may temporarily look attractive to some investors because interest rates are very low, but rising interest rates could once again place pressure on REIT share prices as well as commercial property prices more broadly.

**Table 2** highlights the distribution of REIT indebtedness relative to total assets. On the eve of the credit crisis in 2007 approximately 1/5 of REITs borrowed more than 70% of their asset value – based on the balance sheet value of their properties – with about 8% of REITs very highly leveraged (i.e., more than 80% of their asset value financed with debt). A more sanguine mirage was to look at debt ratios relative to market prices at that time. REIT stock valuations were approximately 40% higher than underlying asset values, implying that none were highly leveraged (see **Chart 1** which highlights the trend in REIT Valuations over the past decade).


The valuation premium was wiped out during the credit crisis and REIT stock prices now equal current asset values. To avoid bankruptcy and prevent leverage ratios from exploding REITs issued new shares as stock prices rose in 2009. Bankruptcy was averted but about 21% of REITs remain highly indebted relative to their asset value. As cash flows deteriorate and interest rates rise, property values are likely to decline further.

### **Things look bad for commercial real estate, but what about the impact on the economy?**

Based on the foregoing analysis between 10% and 20% of REITs are highly leveraged. If the same ratio holds for all commercial real estate owners this implies that between \$350 and \$700 billion in commercial real estate debt is at risk of serious default. So far, except in extremely leveraged circumstances, REITs were able to raise fresh equity capital or work with lenders to extend loan maturities.

Granted REITs are typically in a superior position to negotiate with lenders or raise equity capital, but their situation may provide clues related to the unfolding commercial real estate downturn. Investment returns will likely be very low as fundamentals deteriorate, but lenders will have strong incentives to negotiate with borrowers rather than foreclose. Unlike residential mortgages, the majority of commercial real estate loans are not securitized and the number of borrowers is far fewer.

From the vantage point of stock and bond market investors without real estate exposure in our portfolios we believe the problems in the commercial real estate market will once again cause tremors in the financial system. Unlike the earlier tremors, however, these aftershocks should “only” register 3 or 4 on the Richter Scale, enough to cause short-term problems, but not significant enough to retrigger the bigger financial earthquake. Of course, if the problems in the housing and job markets are not bottoming as recent data suggest, then the macroeconomic problems could be much more severe. We will keep a watchful eye on these trends.

We believe that the growing problems in commercial real estate are not identical to the early problems encountered in the residential real estate market in 2006 and 2007, and we do not believe that commercial real estate woes will cause a repeat of the 2008 financial crisis. We do believe, however, that commercial real estate offers very poor fundamentals at the moment and that these fundamentals will likely deteriorate through 2010. When REITs – and property markets more generally – offer investors higher yields, modest prices and cleaner balance sheets we will once again look for opportunities to invest. 

**Table 1**

Real Estate Investment Trusts		
Average Dividend yield – as of September 30, 2009		
	Dividend Yield	GHPIA Yield Benchmarks
Diversified	3.0%	6.7%
Office	3.7%	6.5%
Multi-Family	4.7%	6.0%
Retail	2.7%	6.0%
Industrial	5.5%	5.5%
Hospitality	0.9%	6.7%
Health Care	6.4%	7.7%

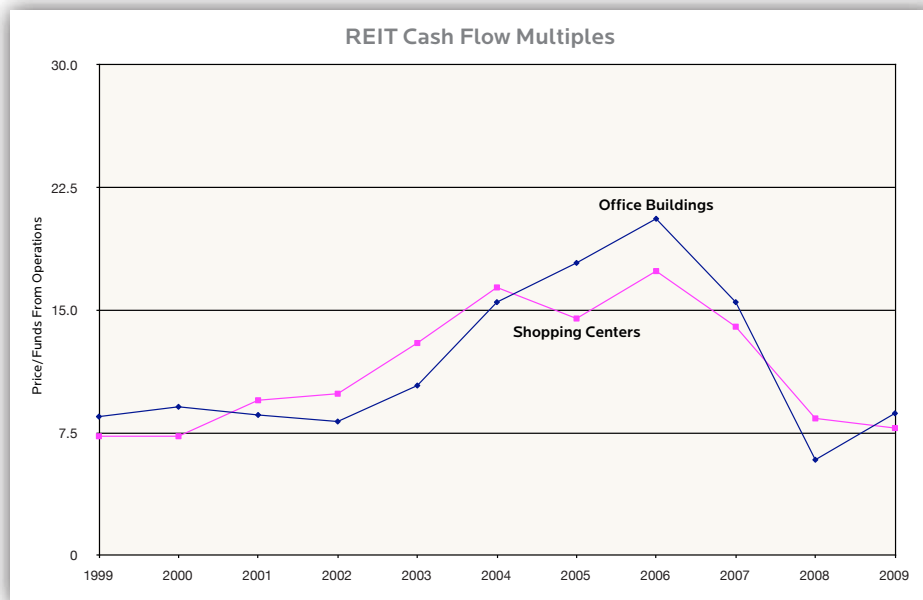
Source: National Association of Real Estate Investment Trusts  
www.nareit.com  
Benchmarks are GHPIA proprietary data.

**Table 2**

Real Estate Investment Trusts		
Total Debt as a Percentage of Total Assets		
	% of REITS 2007	% of REITS 2009
Greater than 90%	4.3%	4.3%
80% - 90%	4.3%	6.1%
70% - 80%	12.2%	11.3%
60% - 70%	33.9%	23.5%
50% - 60%	28.7%	28.7%
Less than 50%	16.5%	26.1%
Total	100.0%	100.0%

Source: Bloomberg, L.P.

**Chart 1**



Source: www.nareit.com REIT Watch



# Market Summary

## Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2009:Q4	P/E Benchmark	Over/Under Valuation	Price/Book Value 2009:Q4	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	19.4	27.0	-28.0%	3.5	5.7	-38.8%
Large-Cap Value Stocks	32.5	20.2	61.1%	1.6	2.5	-34.4%
Mid-Cap Growth Stocks	21.6	24.8	-12.8%	2.7	4.5	-40.0%
Mid-Cap Value Stocks	21.8	19.1	14.1%	1.5	2.2	-33.6%
Small-Cap Growth Stocks	24.7	23.2	6.4%	2.3	3.5	-35.4%
Small-Cap Value Stocks	54.0	18.2	196.9%	1.3	2.1	-37.1%

\*Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 12/31/09.

## Returns by Index

Index	2009:Q4	YTD
DJIA Total Return*	8.09%	22.70%
NASDAQ*	7.20%	45.40%
S&P 500*	6.04%	26.46%
S&P 500/Citigroup Value	4.22%	21.18%
S&P 500/Citigroup Growth	7.76%	31.57%
S&P MidCap 400/Citigroup Value	5.46%	33.73%
S&P MidCap 400/Citigroup Growth	5.63%	41.08%
S&P SmallCap 600/Citigroup Value	4.42%	22.85%
S&P SmallCap 600/Citigroup Growth	5.81%	28.35%

*DJIA & NASDAQ: Bloomberg L.P. as of 1/4/10.*

*S&P Returns: Standard & Poor's (January 4, 2010)  
Standard & Poor's Reports December 2009 Index  
Returns. Press Release.*

*\*Dividends Reinvested.*

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