Real Estate Insights, Forecasts & Strategies

Strategic Advantage

Editor: Christopher Lee

Issue K060110

## "2010 – 2020
## An Unconventional Real Estate Outlook – Part II"

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**Friends & Colleagues:**

Last month I sent you Part I of this two-part **Unconventional Real Estate Outlook**. The response was great and I want to thank everyone who sent comments, additional insights and perspectives. If you missed the Part I issue, you can download a pdf copy at the URL at the end of this newsletter. So here is Part II, unplugged and unvarnished.

To paraphrase the famous Paul Harvey sign off, "And now you *will* know the rest of the story."

One lesson from my years of predicting the future is that it is always a blend of art as well as science. The cornerstone to understanding how the future will look is a function of connecting today's knowledge dots, drawing conclusions and identifying probable outcomes. **While the future is often defined by uncontrollable events, the path to that future is shaped by decisions that are controllable**.

One of my favorite quotes regarding the future is from Franklin D. Roosevelt: *"The only limit of our realization of tomorrow will be our doubts of today."* In 30-plus years of working with many great real estate firms, I've often shared this thought regarding the future*…**"The only limit to your realization of tomorrow's potential will be your doubts about today's decisions."*** Whether we like it or not, the future keeps coming…that's a given. The challenge for real estate firms and their leaders is to better understand that future; and craft and implement a plan to prosper as a result of those probable outcomes.

Over the past several months, I have received numerous requests for an **"Unconventional Decade Forecast"** for the real estate industry. So, the CEL & Associates, Inc. team has been compiling valuable research and background information. While we continue to fine-tune our predictions over the months ahead, I wanted you to read our preliminary findings…our **2010 – 2020 Unconventional Outlook For The Real Estate Industry**.

CEL & Associates, Inc.'s forecasts combine traditional economic models with psychology, qualitative research, sociology, quantitative analysis, market reconnaissance, scenario testing, demography, consumer behavior, generational patterns, historical and philosophical context, proprietary research and interviews. **The blending of these disciplines provides a more predictable series of outcomes**. As Kahlil Gibran said, in *The Prophet* ***"Yesterday is but today's memory, tomorrow is today's dream."*** So it is with our forecasts.

**During the next decade, according to our research, the real estate industry will likely be defined by six words**…six words carrying powerful implications and enormous impact on how real estate is bought, sold, entitled, developed, managed, leased, financed and regulated. These words are:

**The Six Most Powerful Words In Real Estate**
**2010 – 2020**

- Scarcity
- Specialization
- Demographics
- Debt
- Sustainability
- Uncertainty

In our May issue, we examined Scarcity, Specialization and Demographics. Let's take an initial look at the potential impact and implications of the final three words… "Debt," "Sustainability" and "Uncertainty."

## Debt…It Just Keeps Piling Up

Where does one begin? **The massive levels of deficit spending by federal, state and local government agencies is now approximately 40% of everything produced in this country**. The federal deficit rises by $3.9 billion per day. The Obama Administration is preparing to borrow $7.6 trillion over the 2008 – 2016 period. According to the current federal budget, in the next 10 years, taxes on all Americans will rise $3 trillion, and that assumes the near doubling of our national debt. Here are some sobering facts. It should be noted that over the past 50 years, the deficit represented 2.0% to 4.0% of GDP. Current and recent levels are highlighted in the table below.

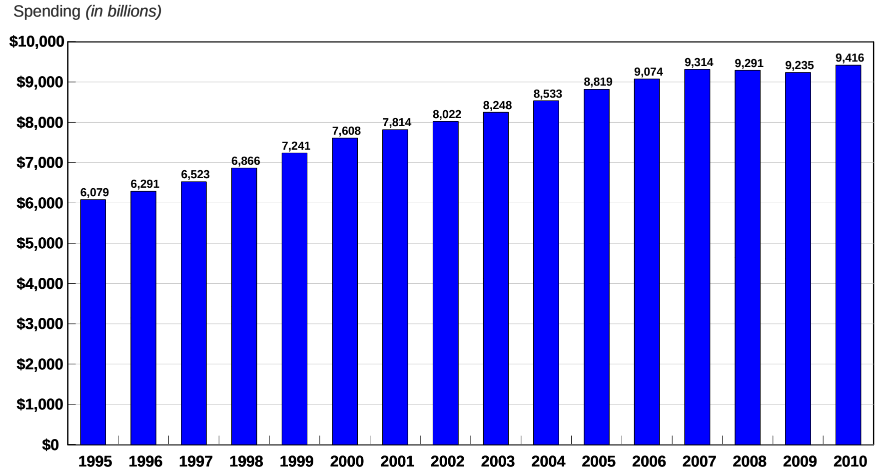
| Year | Proposed Deficit | % Of GDP |
|---|---|---|
| Past 50 Years | | 2.0% – 4.0% |
| 2009 | $1.4 trillion | 9.9% |
| 2010 | $1.6 trillion | 10.3% |
| 2011 | $1.3 trillion | 8.3% |

Note that in the last 50 years the deficit, as a percent of GDP, averaged around 3%, not the current 8% – 10%. By 2020, the U.S. debt will have risen from $7.5 trillion (53% of GDP in 2008) to $20.3 trillion (70% of GDP), and that assumes spending cuts. **The U.S. will spend close to $45 trillion over the next decade—approximately the same amount we spent from 1789 to 2006 combined!** During the past 24 months, the federal government has assumed an additional 4% of the annual U.S. GDP. To see on one screen how massive this problem is, visit www.usdebtclock.org. This is frightening.

Before the recession, federal spending totaled $24,000 per household. Under the Administration's proposed 10-year budget, by 2020 on an inflation-adjusted basis that amount will rise to $36,000 per household. Plus, **how do we pay for the $43 trillion unfunded Social Security and Medicare benefits for the nearly 78 million about-to-retire Baby Boomers?**

This unprecedented federal debt is in addition to the nearly $15 trillion in household debt and $358 billion in 2010 – 2011 state deficits. **As many as 50% of homeowners who have a mortgage, do not have equity**. We are creating a permanent homeowner renter class who, if they are fortunate to be in a growth area, will recapture most of the equity lost over the 2010 – 2020 period. U.S. consumers have around $850 billion in credit card debt.

## U.S. Consumer Spending

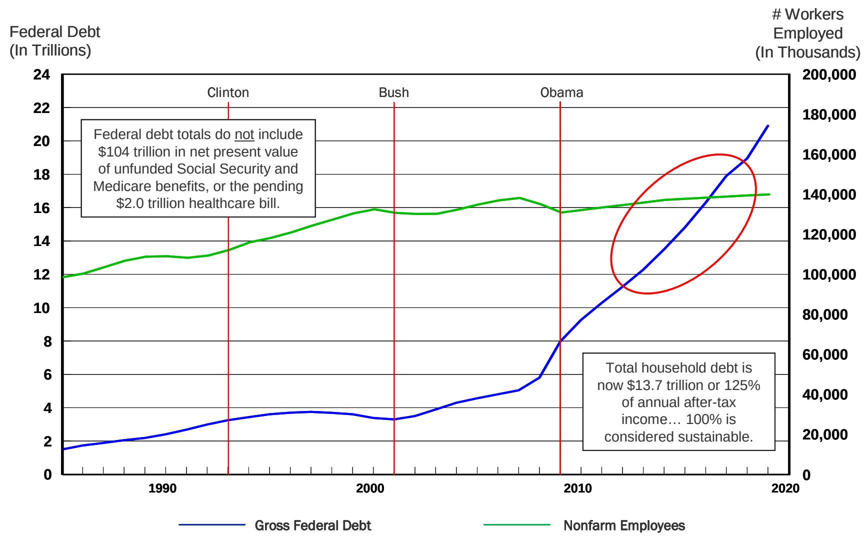



Expressed in 2005 dollars, seasonally adjusted at annual rates. April 2010.

Source: Bureau of Economic Analysis.

Here are my concerns regarding rising debt levels and not enough tax payers to support unprecedented deficit spending. The number of workers in the U.S. is expected to grow at a very modest rate over the next decade. However, the ratio of workers to rapidly rising federal debt levels is not sustainable, and higher taxes will limit rather than incentivize job and overall economic growth, thus significantly reducing demand for real estate assets across the board. Massive federal, state, and local deficit spending will require unprecedented borrowings.

## Ratio U.S. Workers To Federal Debt

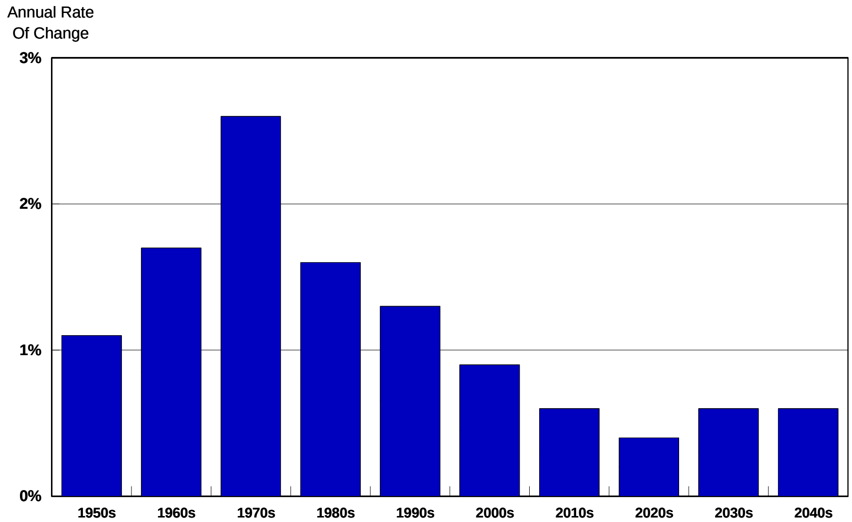



Source: U.S. Department Of Treasury, U.S. Office Of Management And Budget, Heritage Foundation and Congressional Budget Office.

To further highlight the challenge ahead, on May 11, 2010, the Congressional Budget Office confirmed "that the federal government will need to spend an additional $115 billion" to implement the new healthcare law. Employers will pay nearly $90 billion in new employer mandates. The level of deficit spending continues to "go far beyond" what was stated.

Any increase (which is 100% assured) in interest rates will force the government to borrow more, causing additional up-pressure on borrowing rates, and crowding out capital to invest in facilities, infrastructure and expansion and to purchase homes or goods…that would create jobs. By 2020, 35 cents of every dollar paid in individual income tax will go to paying the rising debt. Scarcity of capital will dramatically limit overall economic growth. **More federal and state debt equals lower demands for many real estate asset classes**.

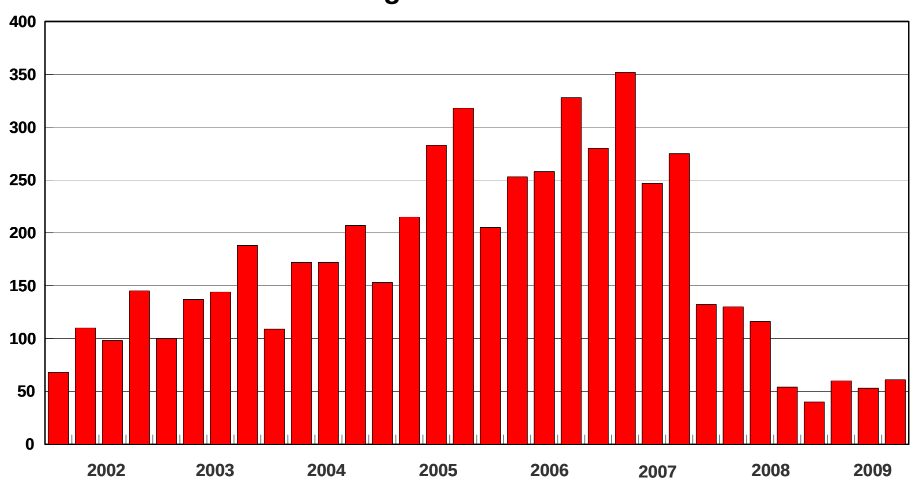
## Annual Labor Force Growth By Decade




Source: U.S. Bureau Of Labor Statistics.

From a borrowing perspective, **the real estate industry will, unfortunately, become a must-be-addressed nuisance with far more rigid lending standards**. While commercial and multifamily borrowings totaled $1.8 trillion between 2000 and 2007, the level of overall commercial real estate loans at the nearly 8,400 nation's banks, totaled $1.9 trillion. Slightly more than $800 billion of commercial and multifamily mortgages are held or related to CMBS, CDOs or other asset-backed securities. Originations by conduit lenders fell 82% on a year-over-year basis in 4Q 2009. GSEs now account for more than 80% of the financing in the multifamily industry. The Commercial/Multifamily Mortgage Bankers Originations Index has fallen approximately 80% over the past 2-year period.

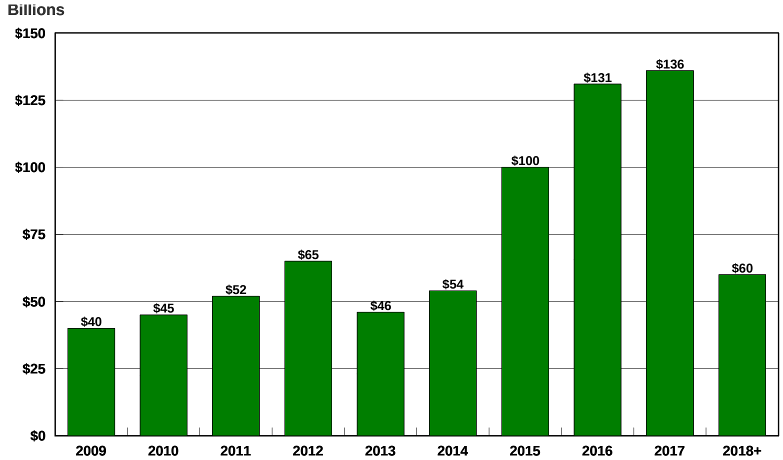
## Commercial/Multifamily Loan Origination Index




Source: Mortgage Bankers Association thru 4Q 2009.

REITs, which sold $24 billion in new stock in 2009, are flush with cash but have few investments to explore. **I expect an uptick in M & A activity over the next 60 months as entity plays may become more attractive than asset plays**.

**U.S. CMBS Maturities**




Source: Goldman Sachs.

The loss of the CMBS market, tightening lending standards, deferred "pretend and extend" refinancings and a general lack of policy focus on commercial real estate lending could pose significant challenges for the real estate industry. The Administration's 2011 budget set aside $867 million to cover the FDIC's cost of resolving troubled banks. A total of 140 banks were closed in 2009 (the highest number since 1992). **Today over 500 banks are troubled, with some estimates that up to 1,000 banks could be shut down over the next several years**. Historically it takes several years to work off excess leverage after a banking crisis. According to Deutsche Bank, "More than $1.4 trillion in commercial mortgages will come due by 2013," with "as much as 65% of those deals having trouble getting refinanced without an infusion of equity or acceptance of lender participation in future upsides."

During 2010 China, the UK and others will take actions toward the withdrawal of monetary stimulus that will cause an overall economic slowdown through the first half of the 2010 – 2020 period. **We may see a "return" of some manufacturing to the U.S. from offshore locations.**

**So what does this mean for the real estate industry in the next decade?** It means that the current (peak-to-trough) 25% – 40% and higher declines in real estate asset values will require more equity, be sold at a significant loss or limp along at barely breaking-even status. It could take many years to recover what has been lost. **It means several more years of protracted brain damage negotiations with lenders, months of uncertainty and voluminous requirements to "paper" the underwriting documentation**. But at the end of the day, if you have an asset loan with a reasonable chance of recovery, you will get that renewal. If you are seeking financing, expect lower LTVs, return of personal guarantees and cross-collateralization, specific loan/asset performance/yield ratios and/or benchmarks, deposit requirements, master lease guarantees and other features. **Interest rates will rise steadily over the decade**.

If you borrow from a government or quasi-government entity (e.g., GSEs), expect new requirements regarding "green features," affordability, community benefit and possible limitations on what is "acceptable" profit. The 2010 – 2020 period will be a decade of re-establishing the New Normal for lending. However, **there are just too many borrowers and not enough capital**. Compounding the U.S. credit problem will be a global credit crisis starting around 2010 – 2013 that will not recover until 2018. The fate of the PIGS (Portugal, Italy, Greece and Spain) is merely the tip of an unresolved credit crisis iceberg.

## Sustainability…An Opportunity And A Challenge

Whether you believe global warming is fact or fiction, nearly everyone agrees that with a growing population, an ever-changing and expanding economy and an increase in the number of commercial and residential buildings, the U.S. is consuming more energy and emitting more carbon dioxide than in years past.

Carbon dioxide accounts for approximately 84% of U.S. greenhouse gas emissions. Residential and commercial buildings account for 39% of all carbon emissions in the U.S. Transportation comprises around one-third of all $CO_2$ emissions in America. U.S. buildings account for 72% of the electricity used. According to the National Science and Technology Council, "if the current trend continues, buildings worldwide will become the top energy consumers by 2025." It is clear that a more effective and efficient use of our resources will contribute to a more sustainable economy and nation. It is in our best interests to become better stewards of what limited and/or shrinking resources we have.

There have been tens of thousands of articles, books, research papers, editorials, speeches and reports written about climate change, sustainability and energy. Type the word "environment" and you get 366 million hits on Google. Type "sustainability" and you get nearly 31 million hits. If you search "sustainable development," nearly 26 million hits emerge. Dialogue, discussion and debate regarding the environment are not a one-time fad or phenomena, it has become an integral part of our daily lives and is clearly front and center within the real estate industry.

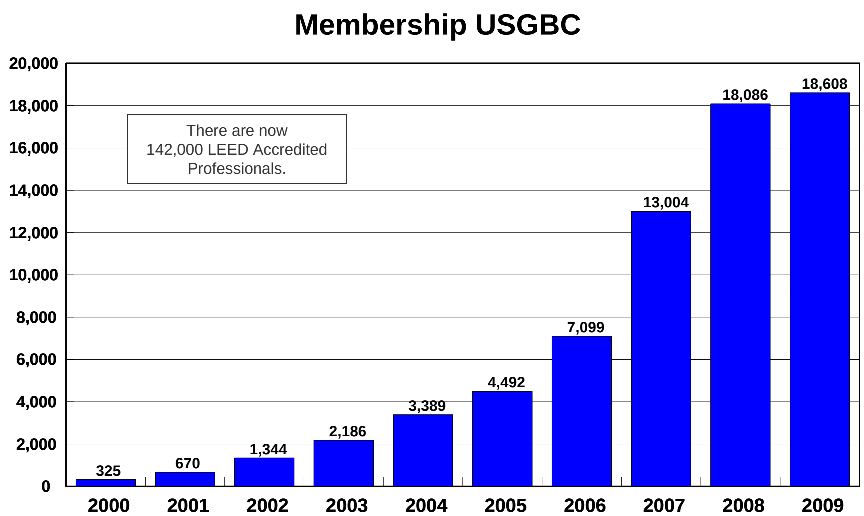
Decisions on what, where and how to develop and redevelop now engage multiple constituencies with varied opinions and perspectives. The real estate industry has become both the poster child for praise and criticism. By 2020 the U.S. population will be around 332 million…52 million more residents than in 2000. The confluence of a rising population, a shift toward a new metropolis and a more responsible use of scarce, buildable land will create opportunities and unexpected challenges. It is very clear from the mountain of research I receive, that with a combination of economic, financial, transportation and demographic shifts, we will see a more dense and diverse urban environment. Reduced use of energy, water and "unnecessary" travel, and more efficient building design and operations will be the focus of building owners over the next several decades. **The 2010 – 2020 period is merely the "starter years" for what will become a sea change of attitudes and systems on how and when to become more energy sustainable.**

Less than 5% of all buildings are LEED certified, or conversely at least 250 billion square feet need to be retrofitted. It is a fact that "high performance building technologies can already reduce building energy consumption on average 35% – 50%. Over the next decade, buildings will be mandated by the federal and state governments and/or regulatory agencies to "reduce one's environmental footprint" or pay stiff fines and/or "energy inefficiency taxes." **By 2020 the U.S. real estate industry (owners and operators) will have become the designated energy czars to reduce carbon emissions**.

From green leases to carpools/ride-share days, from motion-sensored lights to environmentally-friendly tenant improvements, and from recycling to retro-commissioning, the real estate industry will become the de facto leader in the green movement. Training in green construction techniques, green certifications, education and vendor-required green standards will be commonplace. Lenders will reward "green" buildings, investors will prefer "green" buildings and tenants will increasingly demand "green" buildings and "green" building practices.

By 2020 building owners will have or will be in the process of having their buildings LEED or Energy Star certified. Don't be surprised by 2020 to see that a building cannot be sold unless it is "energy compliant" or has escrow monies for energy compliant conversions. Green property management practices will be commonplace. Premiums for rent and asset value will be awarded to green buildings. The primary driver of green building conversions will be as a result of increasing tenant demands.

Today there are over 142,000 LEED accredited professionals and nearly 19,000 U.S. Green Building Council members.



Source: USGBC.

There are around 8,000 EPA Energy Star buildings today. With 72% of U.S. buildings constructed before 1990, the opportunity to "acquire and convert" is tremendous. Watch for the emergence of Green Funds, Smart Growth Funds, Urban Renewal Funds and Energy Conversion Funds as investors seek opportunities with growing tax breaks, governmental incentives and upside potential.

Rising green standards will render many buildings obsolete and targets for "conversion sales." Property Managers will become mini-energy czars. By 2020 investors will be required to underwrite green conversion costs, and there will be new technologies to reduce water and electricity consumption. Roof tops and exterior walls used as gardens will become commonplace. **Don't be surprised to see the first urban farm in an office building by 2020**. Green industry tenants will be some of the fastest growing tenant segments over the next decade. From clean energy to energy efficiency and from the use of environmentally-friendly products to recycling, sustainability will be a transforming word over the next decade.

In addition to the traditional sustainable features of real estate, I believe **the next decade will also be defined by massive improvements to our nation's infrastructure**. Empowered under the guise of "improving energy efficiency," high speed rail lines, new and more efficient water and sewage systems, an upgraded power grid, road and bridge repairs, new transportation systems, improved freight distribution and expanded healthcare facilities are just some of the likely 2010-2020 priorities.

According to recent studies, approximately 90% of the U.S. GDP is produced from the primary, gateway and major cities and metropolitan areas of the country. The shift to a more urban or metropolitan nation will place increasing demands on those services, resources and systems. From antiquated water systems, congested highways, inadequate public transportation systems, decaying bridges, roads and utility systems…the American Society of Civil Engineers estimates that it will take $2.2 trillion over the next five years just to bring current infrastructure up to "adequate" condition. Where is the money coming from?

"Going Green" over the next decade will be far more than a slogan, it will become a behavior. The real estate industry has not only a role to play, but a leadership responsibility to show the way. This is, perhaps, one of the single largest value-add opportunities the real estate industry will have over the next 10 years.

## Uncertainty…Or A Crisis In Confidence

The sixth word that will impact and influence the real estate industry dramatically is "uncertainty." The lack of clarity and direction for everything, including taxes, regulations, incentives, penalties and oversight is:

- Keeping U.S. businesses from hiring
- Restraining investments in new technologies
- Keeping payrolls trimmed and incentives limited
- Contributing to further consumer deleveraging
- Reducing available capital for growth
- Focusing governance toward compliance vs. growth
- Redefining which expenditures are "needed" and "discretionary"
- Delaying long-term business decisions
- Keeping building owners from upgrading/adding green features

The next 36 months could be preoccupied with the 2010 and 2012 elections. If changes occur, how will that impact today's decisions? Better yet, many will wait to see if there will be a change in the legislative power balance.

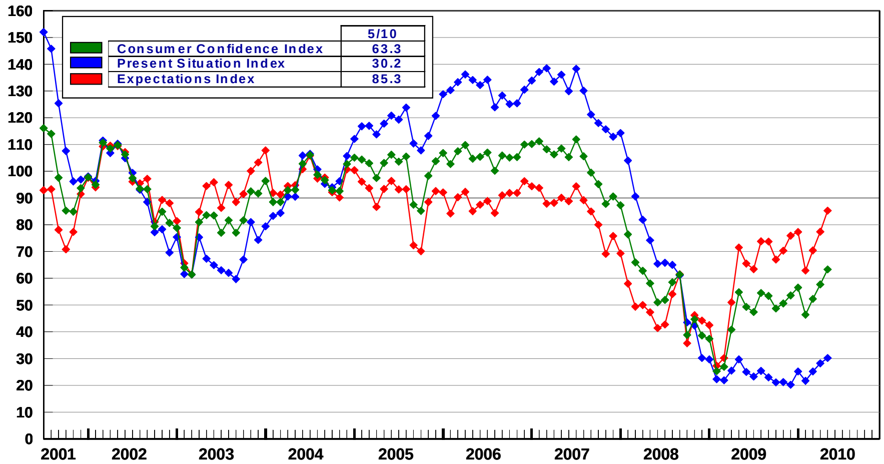
The way I see things unfolding is that citizen, and ultimately voter, unrest over a real or perceived decline in net worth, flat or lower wages, limited new employment opportunities, rising taxes and fees at all levels and frustration that the federal, state and local governments are not applying the same cost cutting choices every citizen is making, could cause a populist uprising. When Americans are unhappy, the solutions become simplistic and the rhetoric of populists.

America is a very resilient and vibrant nation; however, we may be headed for five to seven years of discontent over uncertainty and a lack of confidence in those who are vested with the responsibility to lead. Malaise is too strong a word to describe where we may be headed, but we will need nonpartisan solutions to an American problem. We will need less, not more, government. Hopefully, as one analyst wrote, we won't need an "economic Pearl Harbor" before we seriously address the issues before us. Investors want clarity and the real estate industry needs the confidence to continue to transform the way we live, work, shop, play and stay.

**How can a real estate firm navigate through a decade of uncertainty?** When the uncertainty of a future conflict in the Middle East still looms, when another act of terrorism is likely to occur or when the role of government in society is being debated, how can one acquire, develop or lease real estate assets without rising levels of risk? The constant drum beat of new taxes, fees and penalties is and will continue to keep down business reinvestment and job creation. Who will invest in a future where prosperity is viewed as something that is taxed at a higher rate?

The impact of the proposed environment and/or healthcare legislation, taxes, regulation and oversight is creating a business climate of uncertainty. Consumer expectations or confidence in the future remain low. When Congress begins to determine compensation and bonus levels, why would any corporation want to join in the economic recovery effort? **One phrase heard across the U.S. is, "too much, too fast and too few."**

**Consumer Confidence**
**Continues To Waiver**




Source: The Conference Board.

Following is a partial list of the "unknowns" that will make these next 10 years a period of unprecedented uncertainty; unknowns create a crisis in confidence in those expected to lead and provide realistic/practical solutions. **Apprehension and the "Pending Unknowns" have replaced confidence**.

**<u>The Pending Unknowns</u>**

- Tax Policy
- Terrorism
- Politics & Political Change
- China Meltdown
- Israel/Iran Conflict
- Election Results
- Cap And Trade Legislation
- Access To Capital
- Interest Rates
- Healthcare Reform
- Economic Policy
- Unfunded Liabilities
- Acts Of Nature
- Climate Change
- Slow Growth Policies
- Immigration Reform
- Rent Control
- Job Growth
- Global Tensions
- Rising Deficits
- Inflation
- Trade Policy
- Government Regulations
- NIMBYs And OMDBs

One of the greatest quotes regarding uncertainty is from Jacob Bronowski: *"Knowledge is an unending adventure at the edge of uncertainty."* **In the real estate industry, those who possess knowledge, who can convert knowledge into strategy and strategy into action will be successful over this decade.** It is not what you know, it is what you do with what you know that will matter the most. Uncertainty will be with us, so use it in a quest for reaching and exceeding your potential and that of your organization.

## Conclusion

Three words – "Debt," "Sustainability" and "Uncertainty" – represent the marriage of challenge and opportunity. The impact of these three words will be felt by investors, operators, lenders and users alike as the real estate industry determines probable outcomes and solutions. One thing is certain, business as usual is not a viable option. **Everyone needs a new strategic and long-range business plan to avoid the pitfalls and capitalize on the opportunities created by these three words**.

Real estate firms and their leaders must re-engineer their business models to acknowledge an emerging world of scarcity, specialization and demographics and to capitalize on a knowledge- and relationship-centric business environment and emerging demographic trends.

**The challenge for every real estate entrepreneur, leader and enterprise is to get the timing right, the talent in place to add and create value and the business strategies identified to navigate through this potentially Transforming Decade with tremendous opportunities**. To quote the French philosopher, Voltaire (1694 – 1778), *"Each player must accept the cards life deals him or her: but once they are in hand, he or she alone must decide how to play the cards in order to win the game."* We continue to track many, many real estate opportunities. **Real estate is an ever evolving business of society, and our destiny is not a matter of chance, but a matter of choice. What will you choose?**

If you'd like to share your comments, insights or ideas with me, please email them to newsletter@celassociates.com.

Regards,

Christopher Lee



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***Real Estate Cycles – They Exist…And Are Predictable:***
http://www.celassociates.com/onlinenewsletter/Cycles-2010-SA-K040110.pdf

***Real Estate Outlook 2010-2010 Part I:***
http://www.celassociates.com/onlinenewsletter/RealEstateOutlook.2010-2020-PartI.SA-K050110.pdf