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Boring is exciting

During the downturn the US and Canadian markets have diverged. The latter offers North American exposure without the volatility and baggage of debt of its southern neighbour, and may recover sooner, as Stephanie Schwartz Driver reports

If 2008 has been a tumultuous year in American real estate investment management, 2009 was the year during which the ramifications of over-leverage and lax risk management began to manifest themselves. 2010 looks set to be the year when markets begin to return to normal – but what that new normality will look like is yet to be seen.

In the United States, distress levels are rising as the fall-out from the over-exuberance continues to develop. Reporting on mid-2009 trends, Real Capital Analytics found that, in the Americas, distress levels were up 151% from year-end 2008, rocking up to $136bn (€92bn) – this represents a growth of 76% between the first and second quarters of the year.

Three years on, the most expensive real estate deal of the era – the sale of Stuyvesant Town and Peter Cooper village residential complexes in Manhattan, is facing the possibility of default as the property complex has lost more than half of its value, and its rental income fails to cover even a quarter of the debt payments due from the highly leveraged property. Partners in the deal are BlackRock and Tishman Speyer, and investors include CalPERS, which has seen its own once-lauded real estate portfolio decline 35% in value since the market crash.

There are glimmers of recovery on the horizon. REITs tend to be harbingers of news both good and bad, and by September 2009, the FTSE NAREIT All-REIT index was up more than 76% from what is perceived to be the bottom of the market cycle in March (although it is still down 50% from its peak in February 2007). Many are flush with cash and unsecured debt, ready to capitalise on this property market crash, just as they did in the early 1990s.

Employment growth in the US, however, remains elusive, and this is a key metric for real recovery in the real estate markets. Employment has continued to decline through the first two-thirds of the year, although the declines, month-by-month, have slowed. By September, unemployment had risen to 9.7%, up from 7.2% at the beginning of the year. These figures do not include those who are working only part-time, because they have no other option, or those who are unemployed but have not been classed as actively looking for work for over four weeks. Most commentators expect unemployment to reach double digits by the end of 2009 and to remain there for some time.

The fact that governments worldwide have pumped liquidity into their financial systems, to avoid such defaults as that of Lehman Brothers in 2008 – the shockwaves from which are still reverberating more than a year on – has made forecasting market recovery a tricky prospect, suggests Mark Rose, chairman and chief executive officer of Avison Young, a full-service commercial real estate firm active in Canada and the US.

"With government intervention pumping money into the banks, the banks have been effectively pushing out the problem rather than dealing with capitulation, which has always been the mechanism for cleansing the system in the past," Rose says. "We have been put into a state of suspended animation rather than letting the capital markets work. The $787bn stimulus package was part of a global programme of some $15trn pumped into the global financial system by governments around the world.

"Foreclosures are happening building by building rather than by the dozens – and the United States is at the centre of gumming up the system."

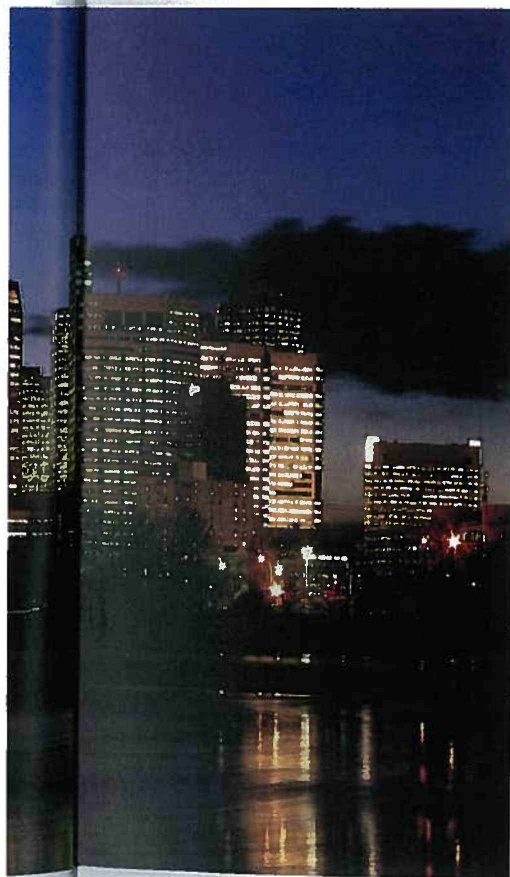
Calgary: a challenging few years ahead

In Rose's view, meaningful recovery in North America is not likely before mid 2010, and may even be pushed out beyond the end of the year. This stands in contrast to other world markets, where property sales for the second quarter of 2009 are showing some indications of a turning point being reached. In Asia-Pacific transaction momentum is indicating a V-shaped recovery, according to Real Capital Analytics, and even in EMEA, a U-shaped recovery is on the cards. In North America, on the other hand, dominated by US turbulence, recovery looks set to stretch into more of an L-shape.

It is noticeable, in the fall-out from the latest crisis, how far the Canadian market has diverged from the US market. "There is little reason to believe that Canadian commercial real estate will see the same level of distress as in the United States," says Remco Daal, president and chief operating officer of Bentall's Canadian operations. Bentall is a real estate advisory and service organisation headquartered in Canada and with offices in Canada and the US; the firm provides real estate investment advice to Canadian pension funds and other private and public institutions.

"Canada has a different market profile. Specifically, there is a greater proportion of institutional ownership, and the leverage employed by the Canadian market has generally been lower than in the US," says Daal. "The fundamentals going into the downturn were quite strong, so many of our clients have been well positioned to weather more difficult markets."

"The Canadian banking system is one of the most stable in the world," Rose maintains. "It did not get involved in sub-prime lending – the average Canadian household holds less than half of the debt of an average American household."



Miami: opportunities in markets that suffered the most

In Daal's view, 2010 will see the recovery of the property cycle in Canada, though it will be later in some markets than in others. Specifically he noted that "the Toronto and Calgary downtown office markets will be challenging in the next few years. Excess supply will have to get worked through, and that will take some time to get absorbed."

As a result of sounder fundamentals, Canada is seeing a return to activity sooner than the US. Rose notes that over the summer 2009, there were more trades on a percentage basis in Canada than there were in the US. Real Capital Analytics measurements back this up: Although the first half of 2009 was down 87%, in terms of total volume of transactions, from the same period in 2008, the second quarter of 2009 was up 33% on the first quarter. This progress contrasts with the situation in the US, where Q2 was up on Q1 only by 1%. (In contrast to both the US and Canada, Latin America was up more than 100% between the first quarter and the second quarter of 2009.)

Canada's current strength makes it attractive to international investors looking to North America, particularly those looking for stable core investments. The stability of the Canadian currency, especially compared to the US dollar at mid-2009, is another incentive "Currency is a significant reason why people want to investment in Canadian real estate," says Daal.

And while recovery from the crash of 2007-2008 will leave the US a changed market, that is not really the case in Canada where the underwriting and the use of leverage was generally more conservative. If anything, the economic downturn in Canada thus far has reinforced the benefits of Canadian real estate as an asset class for institutional investors.

"Investors who have diversified Canadian portfolios have long enjoyed relatively low volatility, solid income returns, and strong appreciation. As the recessionary impacts on the Canadian commercial real estate market work their way through and valuation parameters adjust, investors who appreciate a more stable profile will continue to look favourably on Canada, says Daal. "Others with more opportunistic mandates might focus their attention on the US in the near term as the valuation declines have been steeper."

"In the US I want to see opportunities in distress," says Rose. "Everybody has been looking for opportunities, billions of dollars have been raised to take advantage of distress. The problem is that there are no sellers." There have been some high-profile transactions – Macklowe's Deutsche Bank building is one example – but these examples are too few and far between to represent a trend.

Those opportunitistic investors, biding their time with money in their pockets, may well be on to something, Rose believes. "We will see one of the greatest wealth creation periods once we start to heal. There will be five to seven years of real estate wealth creation and recreation once markets start to move," he predicts.

Rose believes recovery will take around 18 months to two years; following this will be some two years of good behaviour on the part of investors – then, in around five years' time, the excess will begin again.

"Our industry has a history of cycles: if you go back to the Second World War, you can see 14-year boom and bust cycles. So in some ways the last 18 months have not been astonishing at all," says Rose.

"Everybody felt that since the early 1990s, we had matured as an industry, and that the cycles would be more muted. But we also have seen a global financial meltdown, bigger than our industry."

Rose sees opportunities in those US markets that have suffered the most: Florida, Arizona, Southern California and Las Vegas. "Everything there went up 300% – the fact that it's cut in half means that they are still ahead of the game," he says. "It is usually those markets that have hurt the most that come back first."