

The Ground Floor

October 23, 2008

Emerging Trends in Real Estate 2009

Real estate markets in the United States could hit to bottom in 2009 and then flounder for much of 2010, according to the *Emerging Trends in Real Estate® 2009* report by the ULI and New York-based PricewaterhouseCoopers LLP. During this period, ongoing drops in property values, foreclosures, delinquencies, and a limping economy will continue to crimp property cash flows

"Commercial real estate faces its worst year since the wrenching 1991–1992 industry depression," conclude industry experts interviewed for the report, which projects losses of 15 percent to 20 percent in real estate values from the mid-2007 peak. "Only when property financing gets restructured will pricing reconfirm so we can find the floor, and this transition could wipe out companies and people," says one respondent interviewed for the report.

"The industry is facing multiple disconnects," said ULI Senior Resident Fellow for Real Estate Finance Stephen Blank. "Many property owners are drowning in debt, lenders are not lending, and for many (industry professionals), property income flows are declining. There is an unprecedented avoidance of risk. Only when financing gets restructured will pricing reconcile, giving the industry a point from which to start digging out of this hole."

Distress in the housing market is benefiting the apartment market, which the report lists as the number-one "buy." Moderate-income apartments in core urban markets near mass transit offer the best buy, a trend that carried over from the previous year.

Before a rebound, *Emerging Trends* says the following needs to happen:

- Private real estate markets need to correct—lenders must force distressed owners to become motivated sellers.
- Debt capital needs to flow—lenders will need to learn to deal in a more stringent regulatory landscape. The commercial mortgage-backed securities (CMBS) market must "reformulate."
- Regulators need to restore confidence in the securities market. The government will insert itself into overseeing mortgage securitization markets. Systemic overhaul promises more measured debt flow.
- The economy needs to improve. Falling demand for space won't affect real estate markets severely until 2009.
- The housing condition is no better and shows no signs of recovering quickly. For lenders, the "subprime mess is the tip of the iceberg." Stricter lending standards and the weak economy will continue to drain the homebuyer market. "Forget the quick fix!"

The report acknowledges that commercial markets will recover more quickly than most housing markets, and homebuilders may have to sell land tracts for "cents on the dollar" or face foreclosure on their holdings, adding to the already high rate of mortgage defaults and foreclosures.

The main beneficiaries of the real estate downturn in the U.S. are cash-rich offshore buyers, whom the report predicted will continue to take advantage of the weak dollar, and will buy trophy properties in major 24-hour cities. But *Emerging Trends* cautions, "The industry shouldn't blindly count on a restored well-spring to jump-start transactions and development. The dynamics of capital markets have changed dramatically."

Best Advice for 2009:

- Investors should sit tight. Opportunities will surface at significant discounts.

- Buy discounted loans.
- Recap distressed borrowers: invest in maturity defaults, construction loans/bridge loans, or take mezzanine positions and equity stakes in properties.
- Invest in publicly-held real estate investment trusts (REITs). They will lead the market's recovery.
- Focus on global pathway markets: 24-hour coastal cities.
- Staff up asset managers, leasing pros, and workout specialists. Separate good assets from bad.
- Retrench on development and reorient to mixed-use and infill. Higher-density residential with retail will gain favor in next round of building.
- Go green. Cutting energy expenses is likely to be a priority.
- Buy or hold multifamily, hold office, hold hotels, and/or buy residential building lots, but be prepared to hold.
- Purchase distressed condos in urban areas near transit.
- Focus on neighborhood retail centers with strong grocery anchors and chain drugstores

Now in its 30th year, *Emerging Trends* is the oldest, most highly regarded annual industry outlook for the real estate and land use industry and includes interviews and survey responses from more than 600 leading real estate experts, including investors, developers, property company representatives, lenders, brokers and consultants.

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