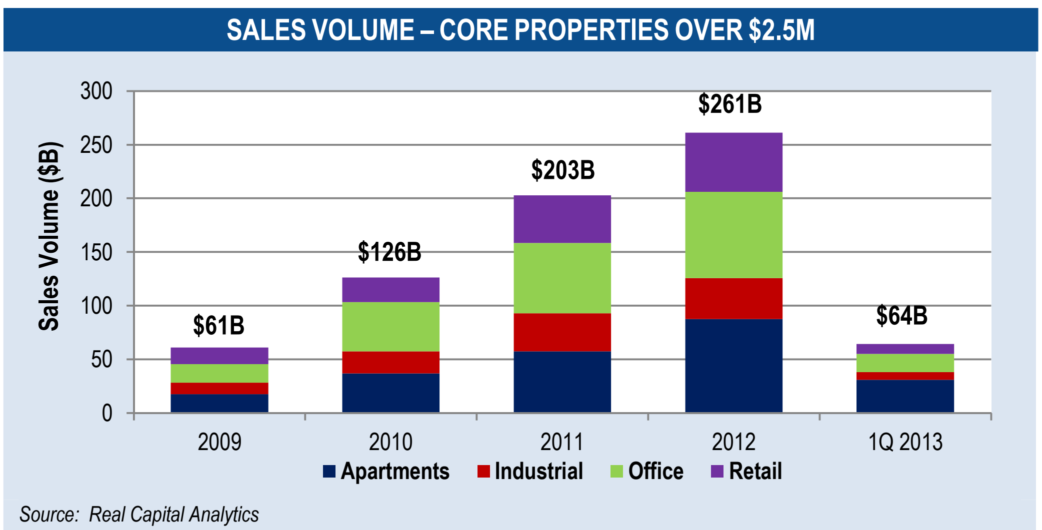
PCCP Market Commentary
Commercial Real Estate Markets: Then and Now
Third Quarter 2013

The U.S. economy appears to have recovered from the financial crisis. Equity markets reached record highs during the second quarter, with the Dow reaching its peak on May 28th at 15,409, an 18% increase from the beginning of the year. Fears of a double-dip recession have subsided behind 2.2% real GDP growth in 2012 and 2.5% projected GDP growth in 2013[1]. With the continued growth of the economy, the Fed indicated that they may begin scaling back their monthly securities buying program. Despite the recent pull back in the markets, most indices are still very much in the positive for the year and the underlying macro-economic statistics are very positive year to date.

Real estate markets have likewise shown signs of recovery. Housing prices have rebounded significantly, with existing home sales prices up 15.4% from a year ago[2]. May registered the second highest total of existing home sales in the last six years. In the commercial sector, sales volume has also increased rapidly over the last few years, as evidenced by the following chart of core property sales volumes:

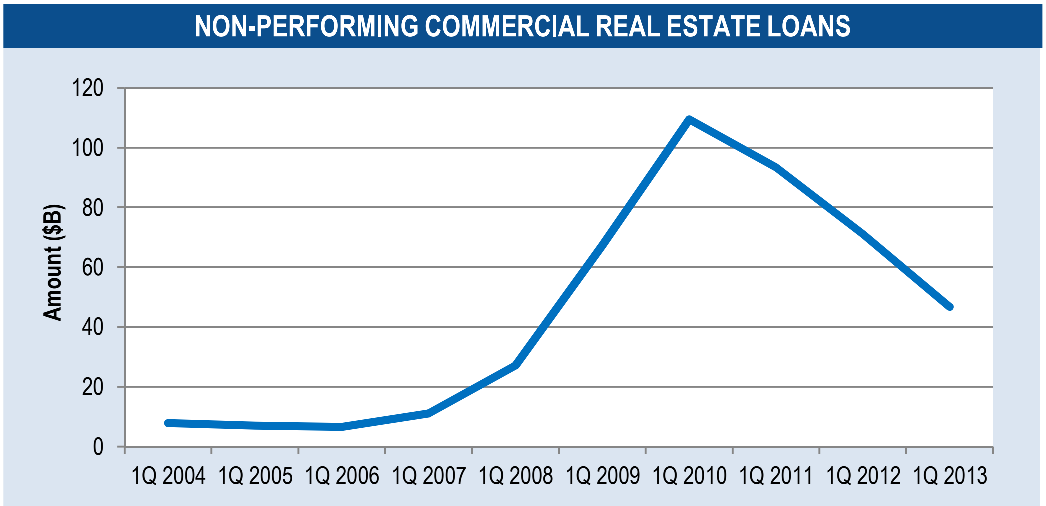


With sales volume rising, prices increasing and capital markets facilitating access to capital, commercial real estate markets are tempting many investors to sing the familiar tune of "Happy Days Are Here Again." However, lest we pull out our harmonicas prematurely, it is important to note that the recovery is on very fragile footing and has been uneven outside of global gateway and energy-related markets. According to Moody's/RCA CPPI Tier 5 Indices which track the top 6 US gateway cities, commercial real estate prices in the major markets are up 47% since the trough, almost double the increase of prices in non-major markets (up 24%)[3]. Thus, secondary and tertiary markets are still 27% below their peak levels in 2007 while tier 1 markets are only 8.6% below.

---

[1] *Wall Street Journal, May 23, 2013*
[2] *Wall Street Journal, June 20, 2013*
[3] *Moody's/RCA CPPI Monthly Report, June 12, 2013*

Also of concern is the persistently high level of troubled loans that are not performing and CMBS debt that is delinquent. While the amount has been falling over the last couple of years, CMBS delinquencies remain relatively high, with the delinquency rate hovering between 9% and 10% over the last 18 months. Similarly, non-performing commercial real estate loans on banks' balance sheets remain well above pre-recession levels, signifying there are still distressed assets (and opportunities) in the market place.



Source: FDIC

Possibly most unnerving is the effect interest rate movements may have on commercial real estate should Ben Bernanke and the Fed decide to pull back their $85B-a-month bond-buying program. With the initial announcement causing the 10-year treasury yield to jump over 50 basis points, S&P analysts recently estimated that the rate increase along with a rise of 30 basis points on yields of top-ranked securities linked to property loans could result in a $15B drop in CMBS issuance[4]. The most recent issuance pricing reflected over a 50 basis point rise in the spread on the AAA's. In other words, prior to the Fed's announcement that they might raise rates later this year, analysts estimated there would be roughly $80B of new CMBS sales in 2013. Now, that estimate is down to $65B, showing just how fragile the recovery is.

Despite the cautionary call regarding the delicacy of the recovery, attentive investors can still find opportunities with meaningful returns in both the debt and equity markets. Recovering, under-saturated markets present occasions to lend at higher spreads; the recent CMBS market volatility will mean continued opportunities for balance sheet lenders. The high level of distressed assets provides equity opportunities for nimble and diligent investors to realize significant value creation. Thus, whether the recovery is truly in full force, or, as we believe, on more tenuous ground, prudent investors will still be able to find value in either scenario.

William R. Lindsay	**Yon Cho**	**Greg Eberhardt**	**K.C. Boback**
PCCP, LLC	PCCP, LLC	PCCP, LLC	PCCP, LLC
wlindsay@pccpllc.com	ycho@pccpllc.com	geberhardt@pccpllc.com	kboback@pccpllc.com
(310) 414-7868	(646) 308-2103	(310) 414-2004	(646) 308-2102

[4] *Bloomberg, June 18, 2013*