An Era of **Less**

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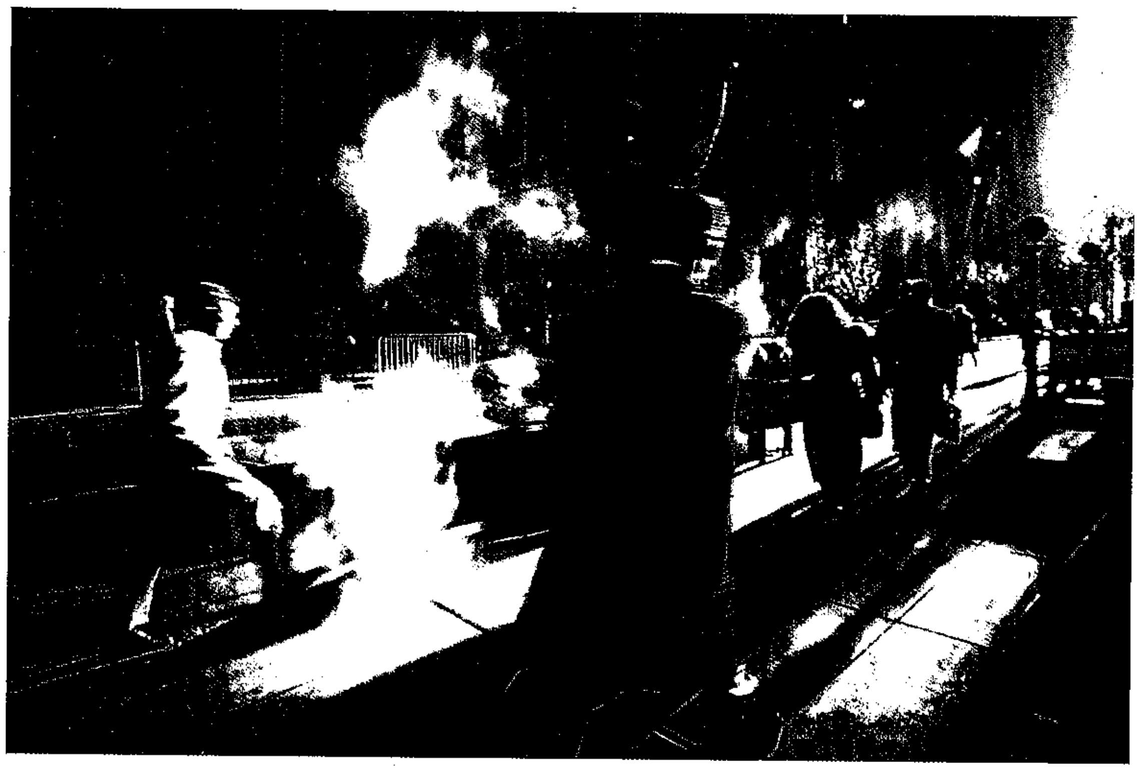
"The problems are obvious, but the solutions oblique."

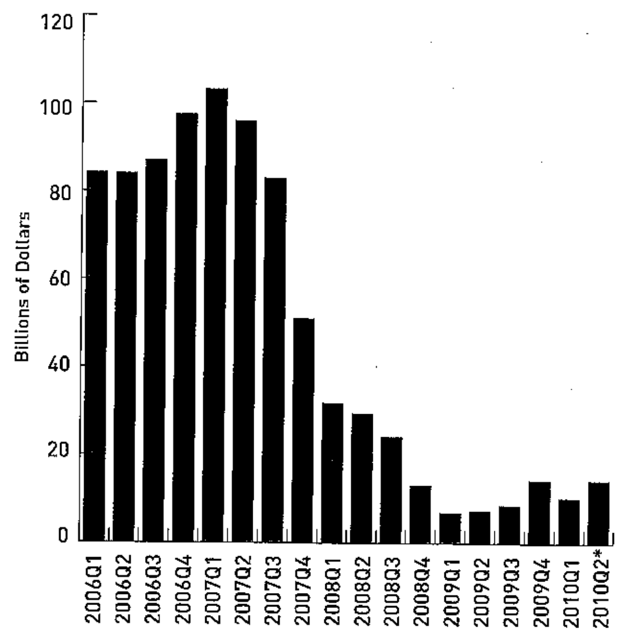
After a hard crash, the real estate world reluctantly is entering a new "Era of Less," characterized by a shrunken industry, lower return expectations, restrained development prospects, reduced credit availability, and crimped profits. Adding to unnerving short-term pessimism, commercial lenders and borrowers finally accelerate recognition of substantial losses—30 to 50 percent haircuts on asset values—from frenzied deal making in the years before the recent steep worldwide recession. Suffering high vacancies and rolling-down rents, limping assets face problematic workouts and uncertain refinancing prospects as hundreds of billions of dollars in loans mature in each of the next four years. Housing, meanwhile, remains mired in a dead zone of reduced demand: many Americans cannot afford new homes, even with record-low mortgage rates and slumping prices. But owners of the sliver of cash-flowing properties in prime gateway markets enjoy significantly better outlooks—a capital flight to quality buttresses prices and balance sheets—and, not surprisingly, everybody falls in love with rental apartments, the king of core-style income-generating investments. These observations come from interviews with dozens of leaders across all sectors of the real estate industry, conducted for ULI's annual *Emerging Trends in Real Estate® 2011* report.

Over the next year, some real estate players will gain significantly. The smart investors who sold near market tops, avoided overleveraging, and kept powder dry are extremely well positioned to take advantage of legions of credit-starved competitors who overborrowed and overpaid. Now, the haves can attract new capital, poach tenants, and lure talent away from the have-nots. Cash-flush investors and reviving lenders will have plenty of opportunities to recapitalize debt-starved, have-not players



and take preferred investment or loan-to-own positions in asset capital stacks, eventually reaping excellent risk-adjusted returns. For lenders back in the game and good-credit borrowers, the bottom of the cycle offers the best environment to employ leverage, especially on high-quality assets, and low interest rates only magnify the opportunity for owners. Investment managers and real estate investment trusts (REITs) with teams to lease properties and nurse asset income streams back to health can bulldoze aside many opportunity fund boutiques, which had depended on cap rate compression and leverage to reap appreciation. "You can no longer make money off flipping," one person interviewed says. "You must be able to manage assets at the property level."

Sales of Large Commercial Properties in the U.S.

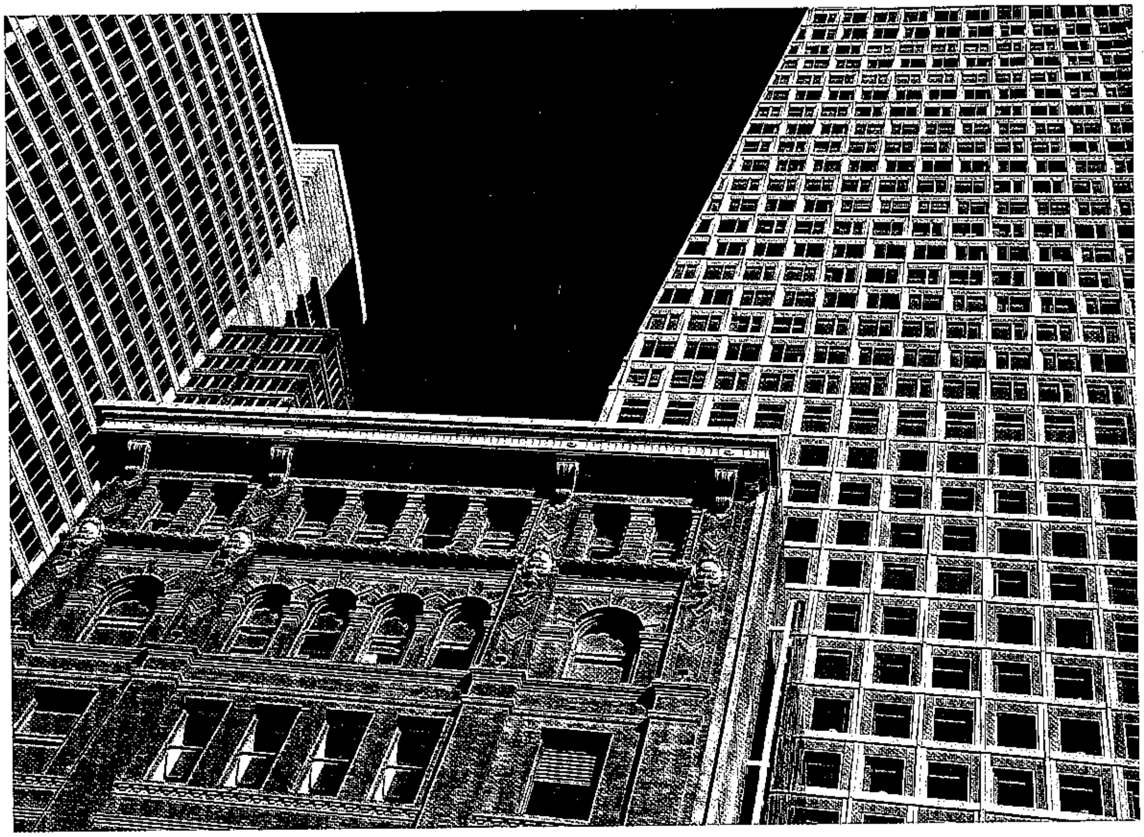


Source: Real Capital Analytics
* Total through June 30, 2010. Limited to properties $10 million or greater.

Gradually, extreme negativity in the commercial real estate universe will abate. For 2011, debt markets will thaw further as money-center banks continue to strengthen balance sheets, take their losses, and step up lending, leading to higher transaction volumes. In addition, left-for-dead conduits will increase activity. This reconstituting marketplace should position real estate once again as an attractive yield-producing asset class for those investors who recalibrate investment expectations rationally. What's wrong with delivering unleveraged high-single-digit returns or low-teens performance for conservatively financed assets? Well, nothing, especially when you consider the dismal record of the stock market over the past decade.

Still, doubts and uncertainty remain about the future and especially the subdued outlook for the U.S. economy, which not only flounders in consumer and government debt, but also struggles to create high-paying jobs competing in a more technology-enabled global marketplace. "Our problems are much bigger than real estate, and solutions are well beyond the scope of our industry," an interviewee says. Americans and their government have been living large off borrowing for several decades, and now the staggering bills have come due. The housing debacle, precipitated by easy credit, has shaken confidence to the core, undermining personal wealth and the sense of a secure financial future. Consumption is taking a necessary breather as people retrench to pay off sizable debts—home mortgages, car loans, and credit cards—and increase savings rates from record-low levels.

The unemployment picture appears more worrisome: even before the recession, wages and benefits had stagnated for the average American.

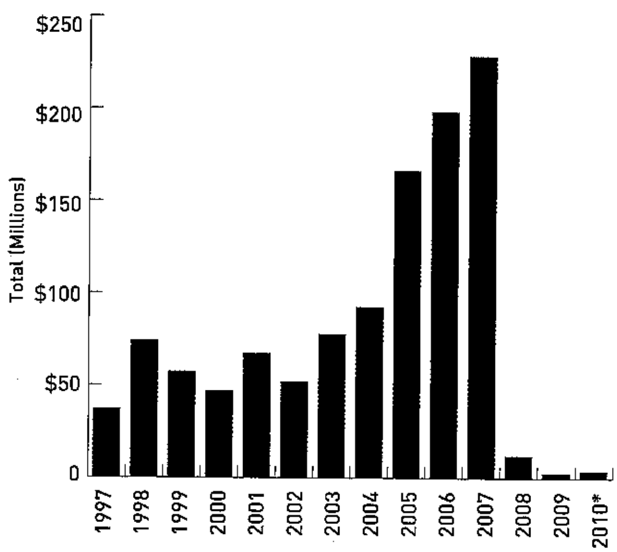


Manufacturing jobs have leached to lower-cost overseas markets since the 1970s, slowly decimating bedrock blue-color jobs. Now the internet and telecom advances allow companies to outsource more professional and service jobs overseas at reduced wages, and various computer applications eliminate office and administrative positions. Many corporate productivity gains and enhanced profits come at the expense of dampening appetites for new hires, and now government belt tightening, especially at the state and local level, eliminates more jobs as stimulus funding begins to run dry. At the same time, corporations cut back on pensions, states grapple to reduce public employee benefits, and just about everyone pays more for health insurance coverage. Again this year, those interviewed for *Emerging Trends* enter a familiar echo chamber, repeating emphatically how real estate recovery "is all about jobs," but suddenly turn silent trying to identify America's high-growth, employment-creating industries of the future.

Homebuilding and commercial real estate construction certainly do not offer much hope for jump-starting jobs or the economy in the near term. "We really don't need much new of anything," an interviewee says. Housing led the economy into the dumpster, and increasing home loan defaults and foreclosures curtail any chance for a sudden rebound. Sobered lenders now expect homebuyers to make down-payments and have solid credit histories before they extend mortgages. Coming out of this recession, many Americans just cannot meet these basic requirements or turn too skittish to take a chance.

Eventually population growth will absorb the overhang in housing supply, but location preferences show signs of shifting away from bigger homes on the suburban

U.S. Commercial Mortgage-Backed Securities Issuance



Source: Commercial Mortgage Alert.
* Issuance total through August 31, 2010.

fringe to infill locations closer to 24-hour markets. Reversing decades of moving away from city centers, "more people will regroup in areas where life is easier, more efficient, and less car dependent"—closer to shopping districts and workplaces—one interviewee says. In the approaching cycle, expect to see more high-rise and mid-rise apartments and townhouse projects built around shopping centers and commercial districts. Failing retail space will be converted to accommodate other uses, often with residential components, and more underoccupied suburban office campuses will be transformed into mixed-use properties. "Coming years will focus on readapting real estate to people's revised goals, priorities, and expectations," one person says. "We'll be working longer, saving more, and looking for greater efficiencies in how we live and work."

Put simply, an Era of Less replaces an era of bigger and more.