

Commercial real estate: Why a rising tide won't lift all boats

Though many observers believe that the recession officially ended in the summer of 2009, most industries, including commercial real estate (CRE), continue to feel its effects. CRE industry fundamentals remain weak, and according to many industry estimates, no meaningful recovery can be expected until 2011 at the earliest. This is not surprising, given that the CRE industry usually lags behind the general economy by 12 to 18 months. The extent and timing of CRE recovery will depend upon geographic market and asset class (e.g., office, industrial, retail or multifamily).

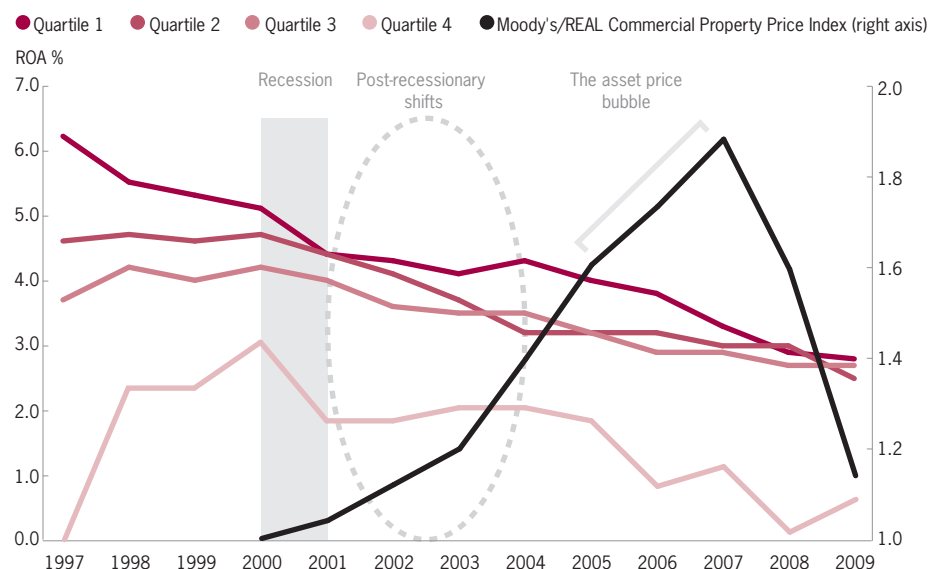
Will the recovery in the broader economy and in local property markets prove to be the panacea for the industry? If history is any indication, companies would be ill-advised to rely solely on this wave of the recovery to remain competitive or even viable.

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Grant Thornton LLP compared the return on assets (ROA) of 100 real estate companies, mainly real estate investment trusts (REITs) with publicly available data, in order to evaluate portfolio performance from 1997 through 2009. This period includes the 2001 recession. The companies were divided into four quartiles based on their ROA at the

beginning of the period, with the first quartile comprising the best performers and the fourth quartile comprising the worst. The yearly median ROA for each quartile was tracked to determine performance trends. In addition, the Moody's/REAL Commercial Property Price Index (CPPI) was applied from 2000 forward to determine pricing trends.

How recession changes the competitive landscape
Median ROA trends by quartile



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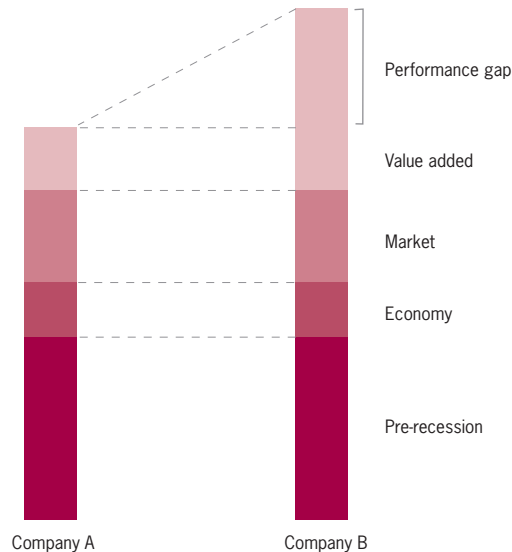
This analysis produced several notable findings:

- The median ROA for each quartile trended downward, with the 2001 recession placing disproportionate pressure on companies in the first and fourth quartiles .
- The median ROA of the top three quartiles converged over time. In layman's terms, this means that the best performers pre-recession enjoyed little or no benefit to ROA performance post-recession compared with the relatively weaker performers.
- Both the 2005–2007 asset price bubble and its subsequent burst are readily apparent. As industry ROA stabilizes and begins to rebound, asset prices will most likely improve, thus reflecting a more normalized relationship between returns and prices.

Our findings suggest that benefits from a recovery are redistributed among industry players and are not necessarily correlated to pre-recession performance levels.

To understand why this might be the case, let us consider the hypothetical example of two CRE companies, Company A and Company B, that are deemed comparable in performance prior to the recession. The recovery in both the broader economy and the local property market will provide a similar boost to both companies. The key performance differentiator is the value added or eroded because of actions taken — or not taken — during the recession. In this example, the net value added by Company A during the downturn fell short of that added by Company B, resulting in a post-recession performance gap between the companies.

What causes the performance gap?
ROA performance of pre-recession peers



Source: Grant Thornton LLP

The reasons for such a performance gap are twofold. First, most companies have a tendency to operate in survival mode during a downturn, concentrating only on short-term results. This thinking often leads to actions that deliver little or no value in the long term; in fact, many

of these actions have the potential to erode value. Second, some companies are overwhelmed and attempt to implement too many changes at once. As a result, very few changes are executed effectively, while important strategic initiatives may be ignored entirely.

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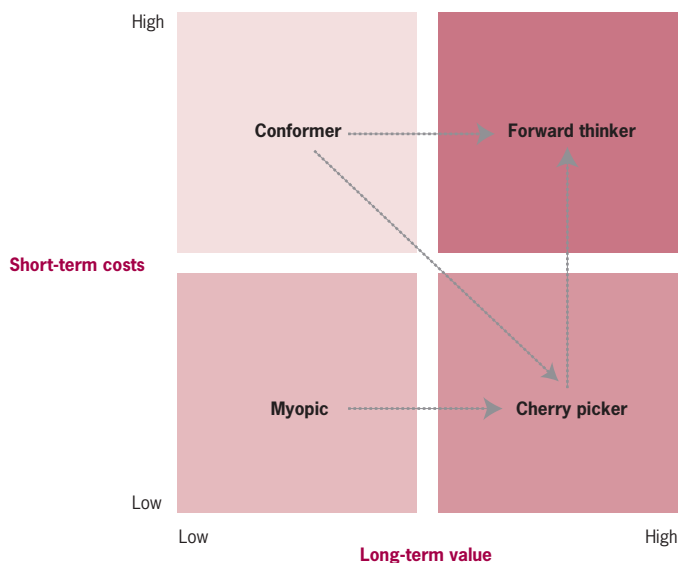
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We recommend that CRE companies map the universe of available actions on a cost-value matrix that has two dimensions: the long-term value added and the short-term costs incurred. Actions taken by the company will fall into one of four quadrants:

- **Myopic (low value, low costs)** — Actions in the lower left quadrant are not costly to implement, but they have low (and in extreme cases, negative) long-term impact. One example of this kind of activity is leasing to risky tenants in order to boost short-term occupancy. Similarly, companies often slash capital spending and selling, general and administrative costs without analyzing the long-term impact of doing so. A company should avoid taking actions that decrease long-term value and should minimize low-impact actions that may distract management from pursuing strategic initiatives.
- **Conformer (low value, high costs)** — Actions in the upper left quadrant are costly to implement and have minimal long-term impact. These actions often relate to problems which should have been addressed previously, such as weak or dysfunctional information and control systems, a lack of discipline in executing agreed-upon plans, and a cash management system inconsistent with stakeholder requirements. Correcting these problems in a shortened time period can be costly in terms of both time and dollars. Companies carrying out actions that fall in this quadrant should attempt to move toward more meaningful, higher-value initiatives that yield more results for the same cost. Alternatively, if limited resources are available after a company completes mandatory activities, it can initiate low-cost, high-impact programs such as those included in the “cherry picker” quadrant.
- **Cherry picker (high value, low costs)** — Actions in the lower right quadrant are not costly to implement, yet they have high long-term benefit. Examples include a review of portfolio performance, disposition of noncore assets, cash generation measures, and a reduction in overhead and discretionary capital expenditures. Because these actions are the corporate equivalent of low-hanging fruit, a company must assume that its competitors are taking advantage of them. Any company that strives to be more competitive must consider investing additional resources in initiatives with the potential to transform it into a market leader.
- **Forward thinker (high value, high costs)** — Actions in the upper right quadrant are costly to implement but have high impact. Most of these actions demand the use of resources — capital, time, labor — without offering short-term returns. Examples include strategic capital investments such as the reconfiguration of leased space, new or redesigned marketing programs, and strategic acquisitions and divestitures. Unsurprisingly, not all companies are willing — or even able — to make such costly investments, particularly during a recessionary period. But it's important to remember that even though these actions do not yield immediate results, they do have the potential to set the business apart from its competitors.

Reaction to the downturn

The four quadrants of company action



Source: Grant Thornton LLP

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The various players in the CRE industry are in a stalemate of sorts. Not enough buyers for CRE assets currently exist, especially if one excludes so-called vulture investors. The lending community is delaying foreclosure procedures and sales of real estate-owned properties as a result of depressed values. These factors foster an environment of stagnation in the CRE industry, and companies may be tempted to limp along and simply survive. However, the CRE industry is about to face a post-recession paradigm it has never seen before. The recovery following the 2001 recession is not a good benchmark because access to capital may be much more severely constrained. Approximately \$1.4 trillion in CRE loans will mature during the next four years. The lending market will probably be flooded with demand, while higher loan-to-value ratios, tighter credit standards and an uncertain securitization market may limit refinancing opportunities. Interest rates

are currently at historic lows, and any material increase in those rates will affect not only the profitability but also the viability of many CRE companies now teetering on the brink. Those that are unprepared for the shift in the industry may find themselves battling for scarce capital — even as they struggle against competitors that took advantage of the downturn to prepare for the recovery.

Therefore, time is of the essence. CRE companies have a limited window of opportunity during this industry downturn to make important changes that will affect their future performance and viability. All new initiatives should be evaluated based on their cost versus their long-term value contribution. The urgent need today is to take forward-thinking actions that will drive future growth.

An economic downturn is no time to stop thinking strategically and is not an excuse for delaying strategic initiatives. Tomorrow's market leaders are laying the groundwork today. •

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Authors

Paul Melville

Principal
T 312.602.8360
E Paul.Melville@gt.com

Sandy Reese

Principal
T 312.602.8960
E Sandy.Reese@gt.com

Alvin Wade

Partner
T 214.561.2340
E Alvin.Wade@gt.com

Howard Adamski

Director
T 312.602.8708
E Howard.Adamski@gt.com

Melissa Dimitri

Manager
T 312.602.8367
E Melissa.Dimitri@gt.com

Abhi Hazarika

Manager
T 312.602.8202
E Abhi.Hazarika@gt.com

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