Strategic Advantage
Real Estate Insights, Forecasts & Strategies
Editor: Christopher Lee

Issue K051512

# "For What It's Worth"

**In This Issue**

- *Consumers Are Hunkering Down*
- *GDP And Economic Growth*
- *Taxmageddon…Are You Ready?*
- *Job Creation Far Below What Is Needed*
- *First Quarter Results Show Conflicting Promise*
- *Closing Comments*

**Friends & Colleagues:**

In the 1960s, folk rock performer Stephen Stills wrote a song called, "For What It's Worth" that became the identity for the band Buffalo Springfield. The song's first two lines eloquently summarize what the real estate industry and the U.S. economy face today:

*"There's something happening here*
*What it is ain't exactly clear"*

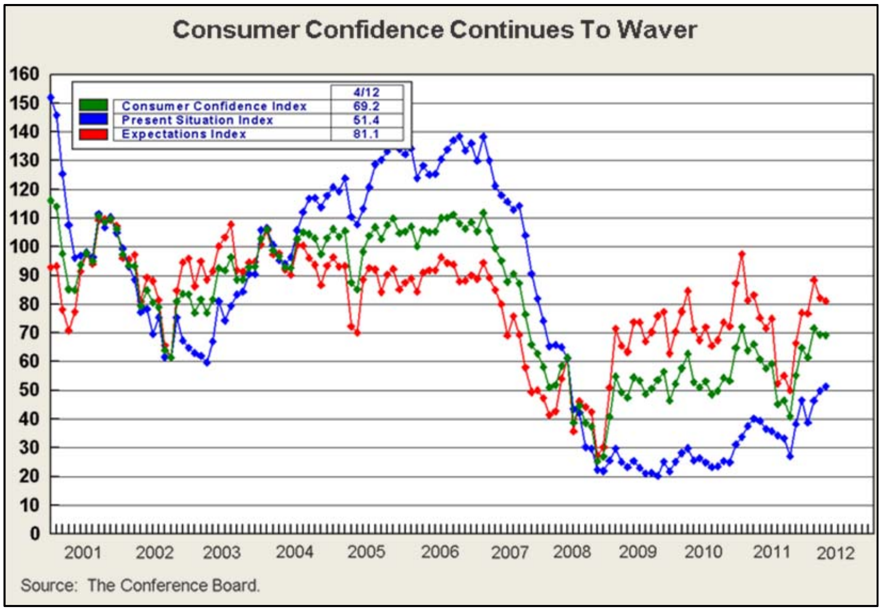
**The striking contrast between the current situation's unknown drama and the fragile outcome that remains elusive perfectly highlights the economic, market and business practice challenges facing the real estate industry.** We are muddling through the gray area between the wheels of inevitability and the struggle for financial balance. While the U.S. economy is in the early stages of a cyclical recovery, growth and prosperity remain inhibited by the seeming inability and/or unwillingness of today's leaders to curtail unprecedented deficit spending and debt accumulation, remedy historically high levels of the unemployed and underemployed, and revitalize subdued employer and consumer optimism.

**Americans, struggling with the complexities of unfulfilled expectations, are reluctant to embrace the simplicity of progress and niche opportunities**. Absent (unwilling or unable) leadership in Washington D.C. and the inherent distractions and legislative inactivity during an election year raise ominous signs of what may be around the corner.

**The tactical containment solutions over the past 36 months have failed to provide the comprehensive strategic solutions required to resolve the challenges**. Declining or stagnant real wages and increases, anemic job growth, stalled consumer confidence, rising energy costs, unstable global economies, depleted home equity and divisive political rancor are not remedies for reinvestment or growth.

Yes, there is something happening here…what it is, in fact, is becoming quite clear. We have moved from the unknown to the uncertain and from apprehension to concern. As the 17$^{th}$ century English physician William Harvey said, "All we know is still infinitely less than all that remains." When I crisscross the country each week, visiting multiple cities and interacting with clients, it is easy to see signs of opportunity and growth amid the concerns and challenges. However, **success in the real estate industry will come from stepping outside one's comfort zone and prior experiences to embrace a focused search for the imagined endeavors of opportunity**. As Yogi Berra said, "If you don't know where you are going, you will wind up somewhere else." Today is the time to take control of your company's future and chart a clear course toward opportunity and success.

## Consumers Are Hunkering Down




While consumer expenditures were up 0.3% in March (an encouraging sign), the warm weather and a slight rise in household income were the likely contributors. Consumer spending for 1Q 2012 rose 2.9% which was the fastest pace in a year. However, after-tax income rose just 0.2% in March and only 0.6% in 1Q (the smallest increase in two years). **How can consumer expenditures rise so dramatically when incomes don't?** Three reasons:

1. Consumers saved less.
2. Credit card debt rose.
3. Other than gasoline, overall household expenditures remained fairly stable.

Another significant but little-known fact is that around 3.1 million homeowners are not paying their mortgages but continue living in their homes. Since 2006 these homeowners have increased their purchasing power by $64 billion. **If current trends continue, the 23% - 25% of homeowners who are underwater are essentially living rent free**. More than 40% of current home loans in foreclosure are over two years past due. The average home equity has declined from nearly 50% of value in the 1980s to only 17%.

**States With Largest Number Of Foreclosures**
**12-Month Period Ending In March 2012**

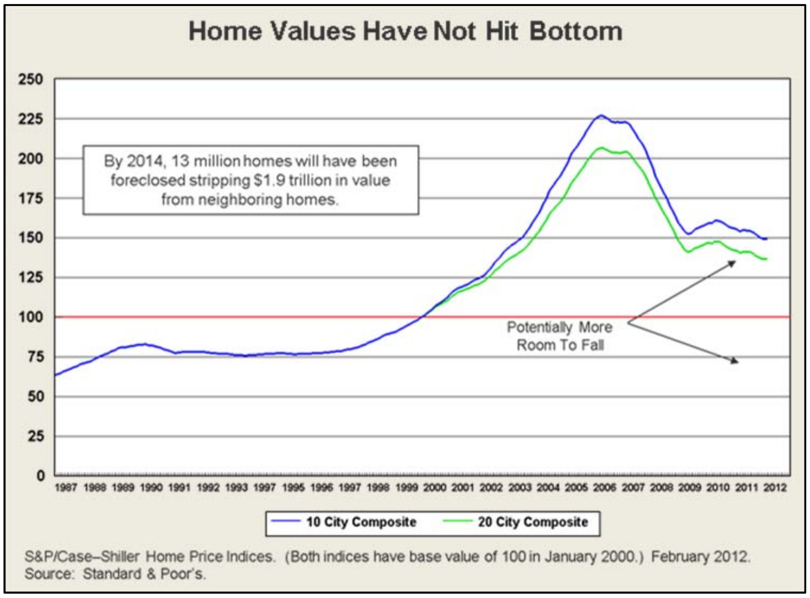
1. **California** – 150,000 foreclosures
2. **Florida** – 92,000 foreclosures
3. **Michigan** – 62,000 foreclosures
4. **Arizona** – 58,000 foreclosures
5. **Texas** – 57,000 foreclosures

*Seven percent of homeowners are now more than 90 days late on their mortgage payments.*

With 78 million Baby Boomers nearing retirement and home equity declines, **I expect savings rates to go up to 10% - 12%** (vs. around 3.8% today and the long-term average of 6.9%), household debt-to-DPI ratios to return to their normal 65% level and overall expenditures to decline as "saving and preparing for the future" becomes the norm for many. I expect homeownership to continue its decline to the low 60s…perhaps dipping into the high 50s.

Did you know that if one assumes all homeowners in foreclosure are really renters, homeownership (65.4%) would be below 60%? Today's homeownership level is at a 15-year low. An increasing percentage of homes are now being purchased by investors for "rental purposes." **In 2011 investors bought 1.23 million homes or 27% of all existing home sales…the greatest annual market share ever recorded.** Half of all investment home purchases in 2011, according to the National Association of Realtors®, were distressed homes. According to some analysts, **home values will decline another 20% or so to return to their historical mean**. This further decline will mean that home values have declined around 47%, and the level of mortgages underwater will increase from 23% to nearly 40%.

CEL & Associates, Inc.

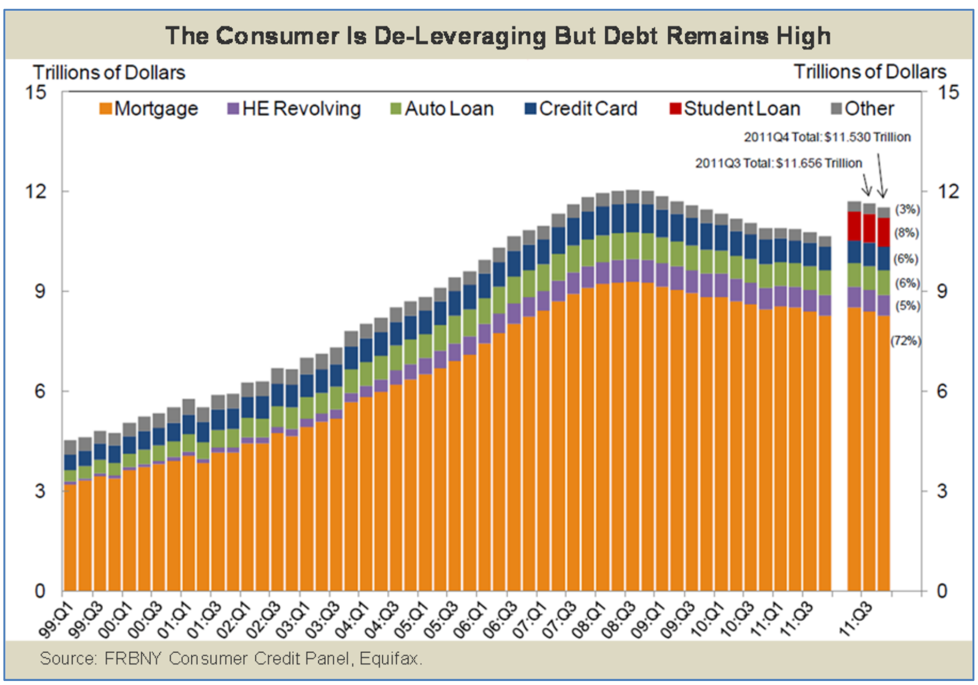



Young couples today delay starting their families by nearly two years, and first marriages (i.e., new household formations) are also being delayed. **The ticking time bombs of student loan debt ($870 billion), car loan debt ($730 billion) and credit card debt ($693 billion) are additional reasons to expect lower long-term consumer expenditures**. Continued fluctuation in energy prices will add another level of *dubitare*…and then there is Taxmageddon only eight months away.

The impact of this trend on the real estate industry will be a Dickens tale of two cities. On the positive side, the apartment, logistics, healthcare, energy, grocery-anchored retail, technology and R&D sectors will do well. On the not-so-positive side, discretionary retail, multi-tenant office in non-core markets, defense-related entities, government, home builders and labor-intensive tenants will challenge the leadership and business models of many commercial-based real estate entities.

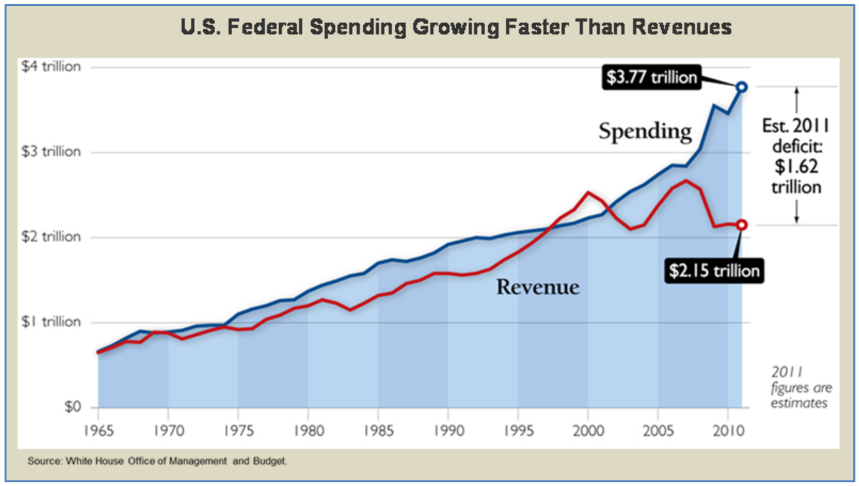
## GDP And Economic Growth

The Congressional Budget Office's ("CBO") recent release of its **baseline budget outlook through fiscal year 2022 reveals a budget deficit of $1.2 trillion in 2012 and averaging around a trillion dollars each year for the 10-year forecast**. Projected GDP growth for 2012 is now expected to be around 2%. Based on the looming massive tax increases **in 2013, the CBO is projecting a baseline GDP growth rate of only 1.1%, hardly an economic recovery**. Historically from 1947 until 2011, the average U.S. GDP growth rate was 3.28%. Many analysts believe the economy is still on shaky ground and an open window of risk still faces many Americans.




Non-residential fixed investments fell for the first time in two years. While manufacturing output is recovering, it remains far below its previous peak. Interestingly, **the labor-intensive jobs continue to leave America, while the robotic-intensive, automated production that requires limited labor appears to be growing**. The April ISM purchasing manager's composite index is now 54.8, around 8.2% below the level of a year ago.

I expect the 1Q GDP numbers will be revised downward, and economists around the country generally believe that the U.S. economy is still fragile. The data is puzzling and of concern, as glimmers of hope shine through and **questions remain whether the signs of momentum can be sustained in 2Q and 3Q**. One of the key indices to watch is the effect high fuel costs have on GDP growth. For every 1% increase in gasoline, the GDP drops 0.02%, so a 10% increase in gas prices would take 0.2% off GDP growth.




My concern, and a subject I have written about in prior issues of *Strategic Advantage,* is the continuing prospect of unsustainable federal fiscal deficits. Even with the Budget Control Act in place, **the CBO projects the fiscal year 2012 deficit to be 7.6% of GDP.** While lower than the 2009, 2010 and 2011 (with deficits of 10.0%, 9.4% and 8.7% of GDP, respectively), these **percentages are around two times larger than historical averages.**

Since CBO estimates are based on "current law," one must rely on analytics to understand the likely outcome. However, it is reasonable to assume that unless there are changes in current spending patterns emanating from Washington D.C., **the U.S. deficit will rise $8 trillion - $10 trillion between 2013 and 2022**. Debt to GDP could rise to nearly 100% of GDP (it was "only" 63.8% in 2007). By 2020, the U.S. could have nearly $20 trillion in gross federal debt. **In 1970, each American's share of publicly held debt was $6,435…today it is $36,267.** Could that rise to $75,000 a decade from now?

A few days ago, France and Greece turned away from fiscal responsibility and moved closer to perdition. **What don't they understand about "living within ones means" or "the money has run out?"** These two countries, and perhaps others soon to follow, are at the tipping point between a painful return to reality or economic ruin. As a further postscript to the recent elections in Europe, **it appears that the G-7 is becoming irrelevant and the G-20 dysfunctional**. Ian Bremmer's new book, <u>Every Nation For Itself: Winners and Losers in a G-Zero World</u>, does any excellent job of describing the leaderless world in which we find ourselves. Perhaps we are moving to a G-2 world (U.S. and China). The ultimate winners will be those who reduce government debt, eliminate sacred cows and escalating entitlements, invest in education and the future, reduce government regulatory intrusion, reward innovation and risk takers, and recognize that the private sector is indispensable for growth and prosperity. **But "kicking the can down the road" like France and Greece is not a solution...it is a sentence of financial servitude.**

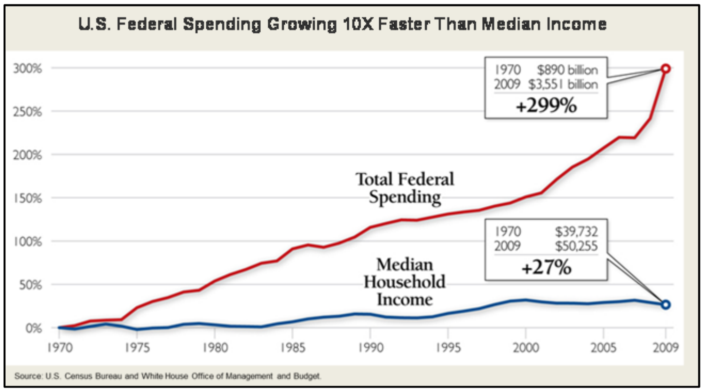
The impact of this reckless spending addiction on the real estate industry will be dramatic and long-term. A lower standard of living, reduced consumer expenditures and higher taxes will negatively impact single-family development, discretionary retail, non-core office markets and the hospitality sectors. Real estate organizations must:

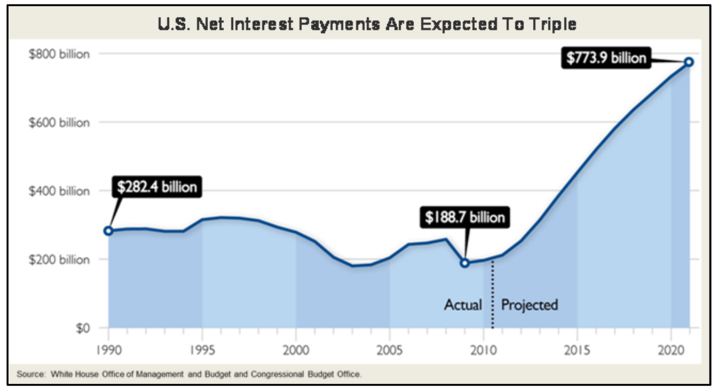
1. Become very client/customer focused.
2. Utilize knowledge to gain a competitive edge and have a clear set of priorities that are aligned with an embraced vision.
3. Rebalance business development activities in dynamic growth markets.
4. Concentrate on "basic" asset classes for development and acquisition.

5. Secure a long-term capital base from which to take advantage of some incredible opportunities.

## Taxmageddon…Are You Ready?

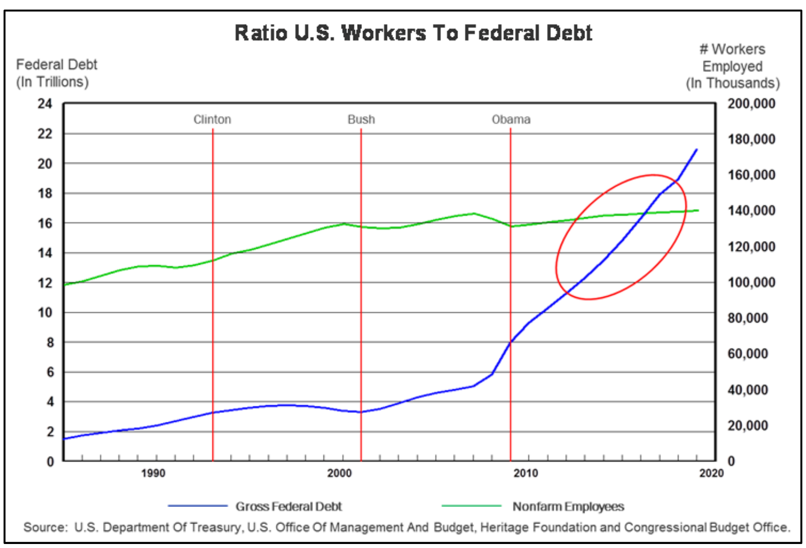
**On January 1, 2013, approximately 230 days from now, Americans will experience the largest tax increase (nearly $500 billion) in American history**. Nearly 34% of the tax increase will come from the expiration of the 2001 and 2003 Bush tax cuts, 25% from the expiration of the temporary payroll tax cut, and 24% from the expiration of the patch on the Alternative Minimum Tax. The remaining tax increases come from the 3.8% surtax on salaries over $250,000 to pay for Obamacare, 15 percentage point increase (35% to 50%) in the death tax, the expiration of all expensing of new business capital investments and other taxes. **If these tax increases are enacted, it will reverse a 14-year national tax policy of reducing the tax burden**.




On April 1, 2012, **the U.S. corporate tax rate of 39.2% was the highest in the world**. The net result has been the sale of U.S. businesses to foreign buyers and reduced corporate reinvestment. The ability of U.S. companies to compete globally is also at risk. A new study by James Gattuso and Diane Katz, Research Fellows at The Heritage Foundation, highlights how **new government regulations enacted over the past three years have cost U.S. business $46 billion…500% higher than the regulations enacted during the eight years of the Bush administration**. While not taxes, these added regulations act like taxes and generally have the same impact of taxes (i.e., a higher cost to consumers).

The impact on the real estate industry will be significant. According to recent studies, the proposed tax plan, if it remains intact, will reduce the inflation-adjusted GDP by $1 trillion between fiscal year 2011 and fiscal year 2020. **Between 2013 and 2019, the average annual job loss (i.e., less job creation) will be nearly 800,000 per year if the new tax increases are enacted**. The U.S. unemployment rate will rise more if the proposed tax plan is enacted than without the tax increase. Business incentives are expected to decline $33 billion below what the level would be without the tax hikes. **The total lost disposable income after subtracting for inflation would be around $726 billion**. Tax rates for higher wage



earners will go up. Small business owners will be impacted significantly (50% of those subject to tax increases are small business owners). The average family of four will lose nearly $9,000 under the proposed new tax plan.

The impact on the real estate industry could be devastating for those without sufficient capital to "weather the storm" and take advantage of a continued pipeline of value-add acquisitions. **I expect investment sales activity to rise 15% - 20% in 2012** as some investors rush to sell and avoid the capital gains tax rate. Owners of retail assets will experience ongoing leasing and collection challenges. Owners of office buildings will experience the impact of limited job growth and reduced demand for "growth" space. **Owners of multifamily assets will see further vacancy declines and rent increases as many 18- to 34-year olds shift to permanent renter status**. Reduced discretionary income also will impact the hospitality industry negatively.

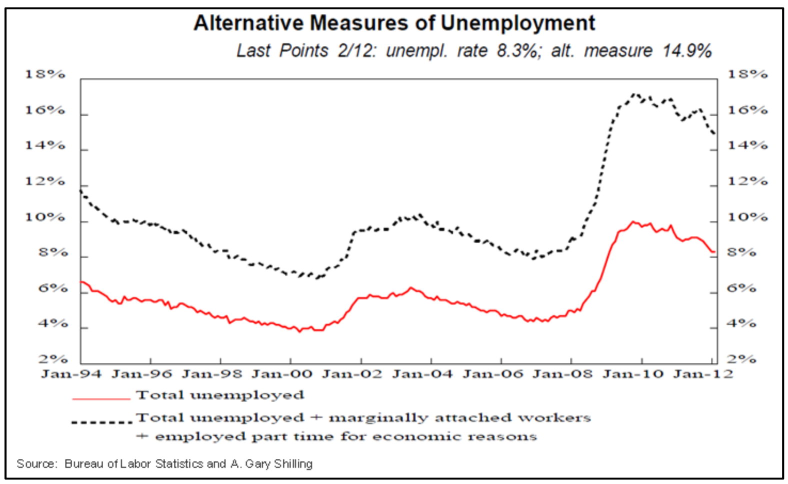
A set of good strategies to deploy include:

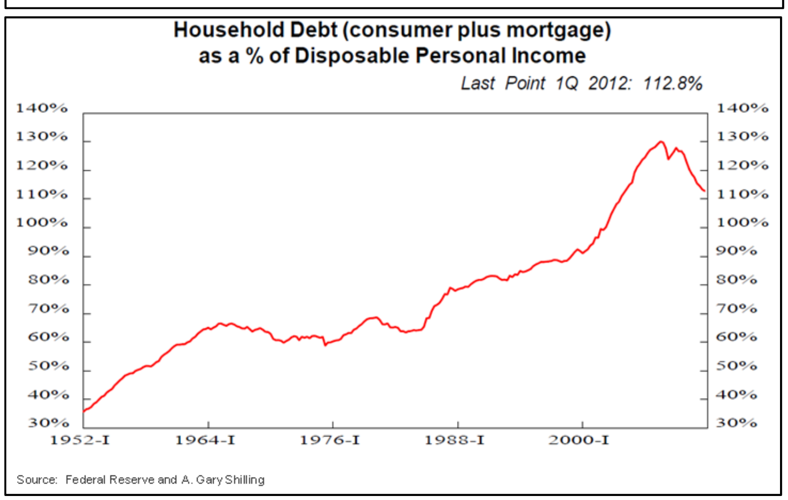
- ✓ Sell a portion of one's assets (say, 15% - 30%) and take money off the table for reinvesting in value-add and opportunistic assets.
- ✓ Refinance and lock in seven- to 10-year debt at today's historically low interest rates.
- ✓ Secure a long-term capital relationship.
- ✓ Focus on growth sectors and markets.
- ✓ Seek more niche and specialized asset redevelopment opportunities.
- ✓ If necessary, review and redesign long-term incentive plans to minimize the impact of future tax increases.

## Job Creation Far Below What Is Needed

**Unfortunately, the April unemployment figure of 8.1% masks the disappointing news that the labor market is still struggling years after the recession officially ended**. The April labor force participation rate dropped to 63.6%, the lowest level since 1981. Nearly 12.5 million Americans remain out of work. **The labor force participation rate for men is at the lowest level.** With the addition of discouraged workers, the rate of unemployment is around 14%-15%.

**Around 5 million jobs must be created to return to pre-recession levels**. However, that number is misleading, since the job market has about 100,000 new entrants each month (1.2 million a year). More than 5.4 million Americans have been unemployed for over six months. The U.S. lost 10 million jobs peak-to-trough in the last recession. Perhaps the most startling statistic is **53.6% of bachelor degree holders under age 25 last year were jobless or under-employed, the highest percentage in 11 years**. According to government figures, only three of the 30



occupations with the largest projected number of job openings by 2020 will require a bachelor's degree or higher to fill the position. There is clearly a mismatch between the shifts needed and talent available. **Employment today is 4% lower than before the recession began 49 months ago.**

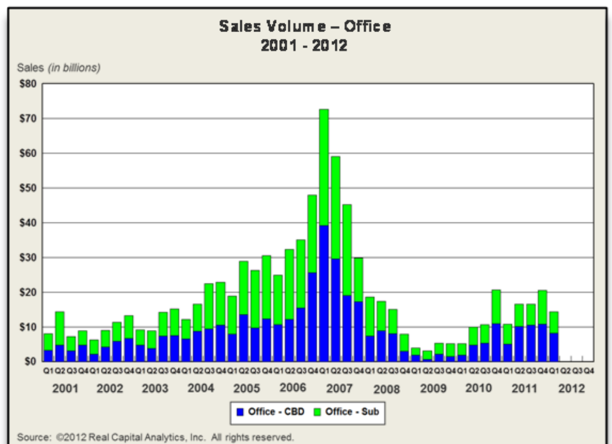
The gap between the highest and lowest paid workers is also growing. Recently released U.S. Department of Labor figures show that between the end of the recession and 1Q 2012, earnings of the top 10% of American wage earners rose 7%...wages for the lowest 10% of wage earners rose only 2.5%. Unfortunately **40% of the jobs created over the past two years have been in low-paying industries** (e.g., retail and restaurants). The looming negative impact of Taxmageddon on job creation, plus the lack of a focus on job creation emanating out of Washington D.C. and several state capitals, is reducing overall tax revenues and placing increased financial burden on government agencies to serve Americans in need. **Today the number of Americans on food stamps is at an all-time high (around 46 million or 15% of the country). Nearly 50% of all Americans now receive some form of government benefit. Around 50% of Americans do not pay income taxes**.

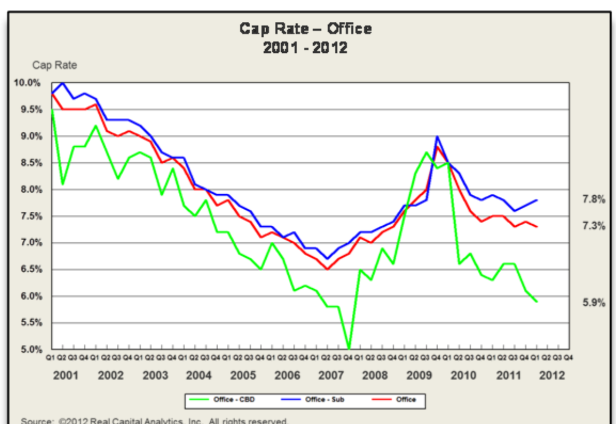
What this dilemma means for the real estate industry is a **patchwork of have and have-not cities and regions, growth and non-growth industry sectors, prosperous and struggling tenants and lower consumer confidence**. Opportunities will be created in business-friendly areas. Healthcare, energy, green, technology, logistics and creative class industries will drive future job growth. Cities like Austin, Seattle, Denver, Boston, Rockville, Silicon Valley, San Diego, Houston, Dallas, Raleigh-Durham and San Francisco will outperform other areas. I like select port cities and major college and university towns. Higher fuel costs and supply chain efficiency could make on-shoring attractive to some manufacturers. However, **without net monthly job creation in the 250,000 – 300,000 range, the U.S. will be in a protracted jobless recovery for several more years**.

## First Quarter Results Show Conflicting Promise

### Office Sector

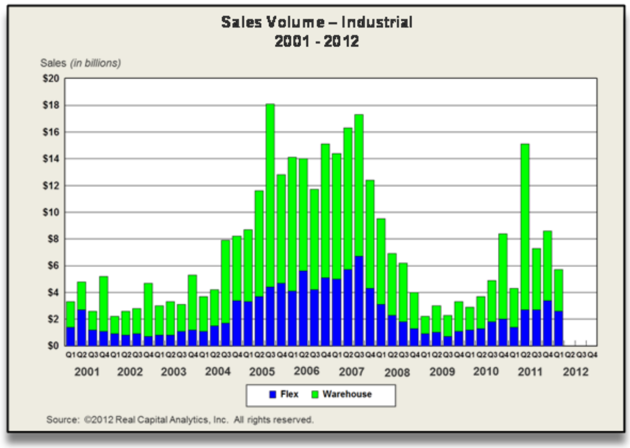
- ✓ According to Real Capital Analytics, 1Q12 sales of significant office properties ($14.3 billion) were up 32% from a year earlier.
- ✓ The sales momentum for office properties has been CBD-driven (65% gain year-over-year).
- ✓ Cap rates are now 7.3%, while the sales price per foot remains fairly flat at around $208.
- ✓ Portfolio transactions were nearly 23% of the sales volume.
- ✓ Markets such as Houston, Seattle, Austin, Dallas and San Diego drew investor attention in the 1Q.
- ✓ Office transactions in the six major metro markets were approximately 60% of the overall sales volume.
- ✓ Overall office fundamentals are improving, and vacancy levels have dropped to the 15.9% - 16% range.
- ✓ However, while conditions are improving slightly, if you are not in one of the top 10 core markets, the overall leasing conditions and investor demand remain weak.
- ✓ Alternative office solutions are emerging and shifting asset optimization strategies.

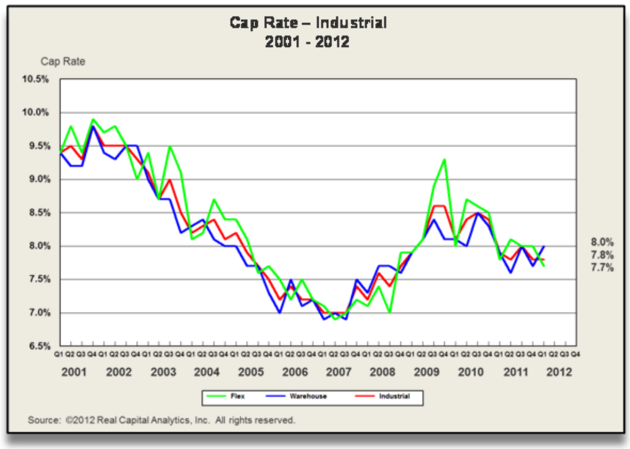


## Industrial Sector

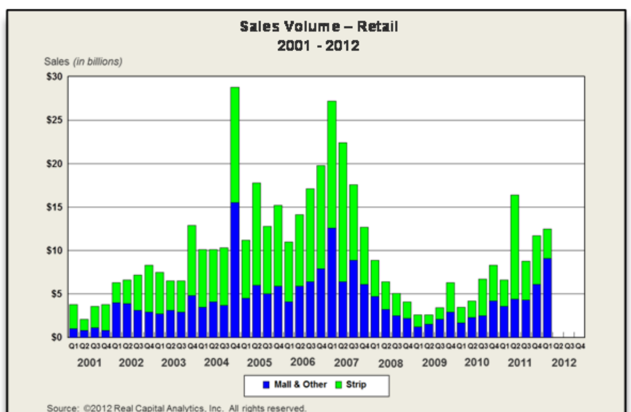
- ✓ Sales of significant industrial property sales in 1Q12 ($5.7 billion) were up 31% from a year ago.
- ✓ The sales momentum for industrial properties has been driven primarily by a dramatic increase in investor interest in flex properties (up 86% from a year ago).
- ✓ Cap rates remain around 7.8%, but deals are being done in the mid-6% range.
- ✓ Portfolio sales were $1.4 billion, and distressed property sales were insignificant.
- ✓ Markets such as Houston, Atlanta, San Diego and Denver garnered most of the investor interest.
- ✓ Industrial fundamentals are improving and warehouse space is in demand, but trade flows are beginning to slow for many reasons.
- ✓ Vacancy levels remain around 13%, and with 25m – 26m square feet of warehouse space under construction, vacancy levels could remain flat through the remainder of 2012.
- ✓ While conditions are improving slightly, overall leasing conditions and investor demand remain weak if you are not in one of the top 10 core markets.

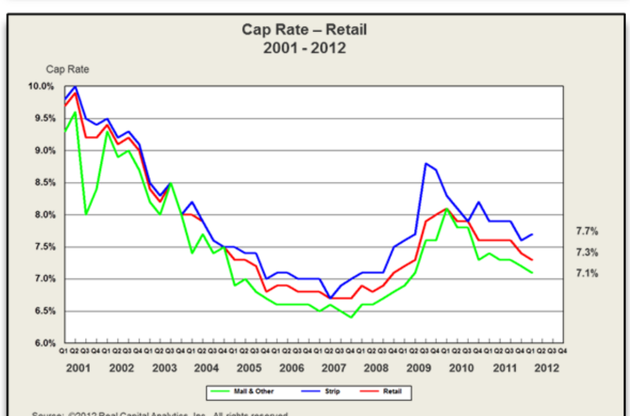



## Retail Sector

- ✓ Sales of significant retail properties, according to RCA, totaled $12.5 billion in 1Q12…up 87% from a year earlier.
- ✓ Same store sales in April were less than 1% which was disappointing.
- ✓ Cap rates dropped to around 7.3%, or $167 per square foot.
- ✓ If you are an owner of retail assets, now is the time to seriously consider a sale. It is becoming difficult to find core assets at a price that makes sense, so core asset portfolios are attracting premium pricing.
- ✓ Sales of retail assets nearly doubled in Salt Lake City, Houston, Atlanta, San Antonio and Minneapolis.
- ✓ Markets like San Francisco, Boston and Metro New York continued to attract investor interest. "B" assets are now in demand.
- ✓ Nearly 700 retail properties changed hands in the 1Q12.
- ✓ Vacancy levels remain around 10% - 11%, however, rents hovered at or around their 2005 levels.

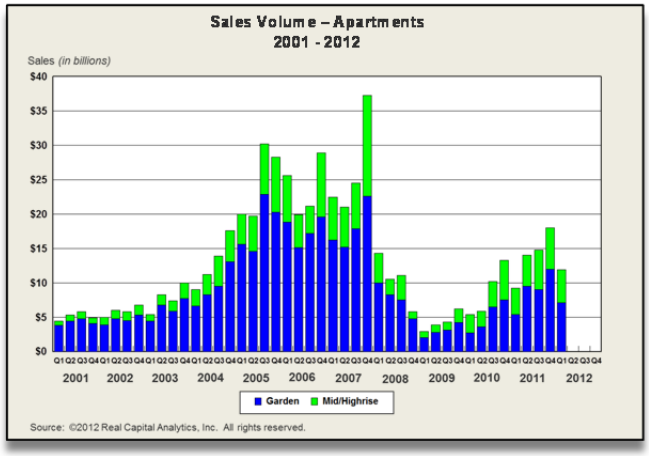


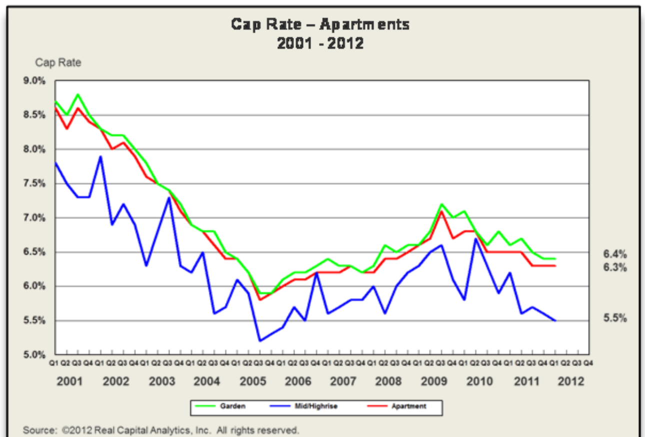




CEL & Associates, Inc.

## Apartment Sector

- ✓ Sales of significant multifamily properties ($12 billion) in 1Q12 were 31% higher than a year ago. Garden apartments were $7.1 billion of that total. A total of 854 properties were sold in 1Q12.
- ✓ Cap rates have dropped to around 6.3%. There were rumors that several properties in core markets traded for under sub-5 cap rates.
- ✓ One in five adults age 25-34 lives with parents…the highest level since the 1950s.
- ✓ Markets such as Austin, Raleigh, Seattle, Boston, San Francisco and San Diego are attracting investor interest.
- ✓ Of the 50 major U.S. cities, 26 have vacancy levels below 5%.
- ✓ Around 55% of distressed apartment properties have been resolved. New instances of distressed apartment assets have fallen to their lowest level since 2007.
- ✓ New investment opportunities are being found in secondary markets.
- ✓ Vacancy rates are around 4.9%, the lowest level since 2001.
- ✓ There are now around 180,000 apartment units under construction, and the risk of overbuilding may be growing in some markets.




## Closing Comments

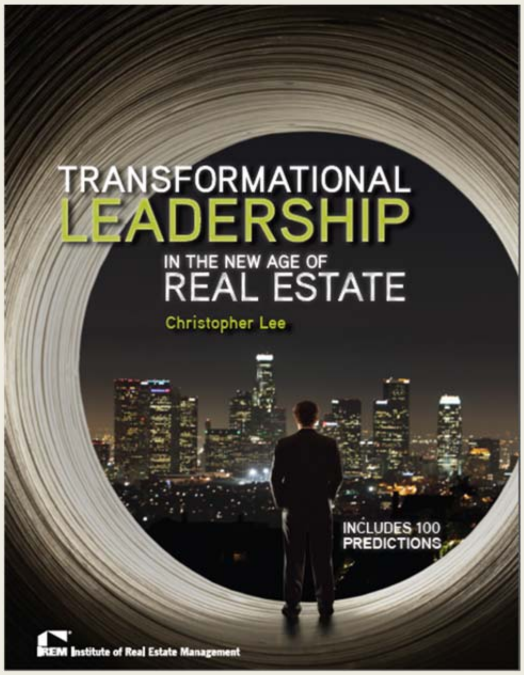
There is, indeed, something happening here. Years from now, I believe we will look back at the 2010 – 2013 period and **call it the "should've, could've, would've" time**. Many incredible opportunities are available to those who have the insight, leadership, knowledge, talent, capital and plan to win. Rather than react to today's malaise, you must engage in proactive solutions, make thoughtful decisions and enjoy the journey. If you don't…"it will be for what it's worth."

To share your comments, insights or ideas, please email them to newsletter@celassociates.com.

Regards,

Christopher Lee

## JUST RELEASED!




★★★★★

Surviving, prospering and achieving a competitive edge in today's marketplace can be challenging. *Transformational Leadership* is a book that traces the history of real estate, provides insights into what's ahead, highlights the timing of the next real estate cycle and provides strategies on how to succeed and thrive. The book also includes 100 predictions you will find fascinating and thought-provoking.

Simply click on this following link *IREM* and you will be directed on how to purchase your copy.

*Full text link is below:*

http://www.irem.org/acb/stores/1/_font_color_990000_New_fo_P23758C1.cfm?UserID=33602960&jsessionid=5a30da3a2408$10$87S$

## *DON'T MISS OUT*

### *CEL & Associates, Inc. 23rd Annual National Real Estate Compensation & Benefits Survey*

***There Is Still Time To Participate. The Due Date Has Been EXTENDED to May 23, 2012.***

CEL & Associates, Inc. is pleased to **Partner with both NAIOP (Commercial Real Estate Development Association) and NAA (National Apartment Association)** in the 2012 Compensation Survey.

This will be an important year for decisions related to employee compensation levels, retention and morale. **Please have your HR executive contact Janet Gora at janet@celassociates.com if you would like your company to participate in the survey.** All Participants receive the full Complimentary Summary Report of all positions and information (PDF and Excel electronic reports).

**Thank you to those companies that have already completed their survey for 2012.**

***Give Us Your Opinion:*** We want to hear from you and to have future issues reflect your needs and questions. Please email your comments, ideas, suggestions and insights to newsletter@celassociates.com.

***For More Information:*** For more information regarding our services (Strategic Planning, Compensation, Opinion Surveys, Benchmarking, Performance Improvement, Succession Planning and Governance/Management), please email us at newsletter@celassociates.com or call 310.571.3113.

***To Subscribe:*** To subscribe to CEL & Associates, Inc. and Christopher Lee's *Strategic Advantage* newsletter with ongoing insights, opinions and forecasts regarding issues, trends and opportunities within the real estate industry, please email us at newsletter@celassociates.com with *"Subscribe"* in the Subject line and provide your full contact information.

***To Change Your Contact Information*:** Please email us at newsletter@celassociates.com with *"Change Contact Information"* in the Subject line and include your new contact information.

**Disclaimer:** The opinions, forecasts, information and insights presented in this article are of a general nature and do not constitute the provision of investment, management or economic advice to any person, organization or governing board, and this article does not contain any recommendation(s) to buy, sell and/or invest in any security, real estate asset, fund or adopt as an element of any investment strategy. Opinions and forecasts expressed herein are subject to change without notice. Relevant information was obtained from sources deemed reliable. Such information is not guaranteed as to its accuracy.

***Prior Newsletters: If you would like to download prior newsletters, please go to the following links.***

***Becoming A Customer-Centric Company***

*http://www.celassociates.com/onlinenewsletter/BecomingACustomer-CentricCompany-SA-K040212.pdf*

***It Is Time To Get Rid Of Oldco!***

*http://www.celassociates.com/onlinenewsletter/TimeToGetRidOfOldco-SA-K030712.pdf*

***2012…A Year of Dubitare***

*http://www.celassociates.com/onlinenewsletter/2012...AYearOfDubitare-SA-K011712.pdf*

***Growth Is An Art As Well As A Science***

*http://www.celassociates.com/onlinenewsletter/GrowthIsAnArtAsWellAsAScience-SA-K112911-CEL.pdf*

***A Contrarian Perspective***

*http://www.celassociates.com/onlinenewsletter/AContrarianPerspective-SA-K110211.pdf*

***The Role Of Real Estate In Society***

*http://www.celassociates.com/onlinenewsletter/TheRoleOfRealEstateInSociety-SA-K091411.pdf*

***Prospects For A Real Estate Recovery Could Wait Until 2013***

*http://www.celassociates.com/onlinenewsletter/ProspectsForRealEstateRecovery-SA-K082211.pdf*

***Tomorrow Has Already Arrived***

*http://www.celassociates.com/onlinenewsletter/TomorrowHasAlreadyArrived-SA-K062711.pdf*

***Age Of Consequence & Opportunity***

http://www.celassociates.com/onlinenewsletter/AgeOfConsequence-SA-K050611.pdf

***Take Control Of Your Destiny***

http://www.celassociates.com/onlinenewsletter/TakeControlOfYourDestiny-SA-K032911.pdf

***Real Estate Outlook 2010-2020 Part II***

http://www.celassociates.com/onlinenewsletter/RealEstateOutlook.2010-2020-PartII.SA-K060110.pdf

***Real Estate Outlook 2010-2020 Part I***

http://www.celassociates.com/onlinenewsletter/RealEstateOutlook.2010-2020-PartI.SA-K050110.pdf

***Real Estate Cycles – They Exist…And Are Predictable***

http://www.celassociates.com/onlinenewsletter/Cycles-2010-SA-K040110.pdf