



Pensions Sharpen Focus on Mark-to-Market

After months of struggling with over-inflated real estate values, institutional giants have begun to reprice their property portfolios. **By Ben Johnson**

Despite a dearth of transactions, pension funds are finally in the throes of writing down the value of their commercial real estate assets in the face of a troubled economy and clogged credit markets. While the write-downs by these industry bellwethers will effectively balance their allocations to the

sector, the move has sweeping implications for the funds' investment strategies in 2009 and in the years ahead.

Pension fund advisors spent the first two months of 2009 wrapping up their year-end reporting with many advisors using aggressive mark-to market programs, or bringing the value of their

real estate assets more in line with actual market pricing. "The plan sponsors are putting a lot of pressure on their advisors to mark to market as much as they can so that they can just move on," says Greg Vorwaller, president of investment properties with CB Richard Ellis in Chicago.

“It’s safe to say that real estate values have not been written down yet to reflect current valuations, but that’s actively happening.” — Jim Woidat, principal, Kingsley Associates

Recent property pricing levels certainly point to a continued decline. The National Council of Real Estate Investment Fiduciaries (NCREIF) fund index, which measures pricing changes at stabilized commercial real estate properties, dropped 10.92% in the fourth quarter of 2008 compared with the prior quarter. The S&P 500 was off nearly 22% during the same period.

“It’s safe to say that real estate values have not been written down yet to reflect current valuations, but that’s actively happening,” says Jim Woidat, a principal with researcher Kingsley Associates in San Francisco. The firm recently completed its 13th annual survey of 100 top institutional investors, in partnership with Institutional Real Estate Inc., a publishing and consulting company based in San Ramon, Calif.

“Investors do expect significant write-downs in their property values in 2009,” says Woidat. Survey respondents predicted that their real estate values would drop by an average of 8.3% in 2009. “I think it’s going to be a lot more dramatic than that, but the bottom line is that investors are expecting write-downs in their current holdings,” says Woidat. “But it makes another challenge for 2009 in

that pension funds certainly aren’t very comfortable investing into a property market that may be somewhat of a falling knife.”

The net effect of lower real estate values will be an easing in the “denominator effect.” For the past year, many pension funds have seen the value of their real estate assets push past their allocation targets, which are measured as a percent of total assets under management.

But as the value of the funds’ other managed assets falls — most notably stocks and bonds — the value of other assets rises, often pushing past preset limits. Stocks and bonds are valued on a daily basis in the public markets, but commercial real estate assets are much less easy to quantify.

A moving target?

Marking to market affirms what nearly every property investor has known for some time — that property values have been falling. But the process has been slow to occur, and for good reason. Valuing any commercial property in a market that is best characterized as stalled presents appraisers with a unique set of challenges.

“The good news is the pension funds

want to get mark-to-market done,” says Vorwaller. “The getting it done part is a little more problematic because those in the valuation business would suggest that they don’t have the comprehensive set of comparable sales or data points they used to have due to the diminishing level of transacting activity last year.”

For now, appraisers are muddling through the situation by comparing deals in similar-sized cities and making the appropriate market adjustments.

One closely watched barometer is likely to be a new survey conducted by the Massachusetts Institute of Technology’s Center for Real Estate. According to the survey, prices for properties sold from the NCREIF database dropped by 10.6% in the fourth quarter of 2008 compared with the previous quarter. Stated another way, prices have dropped 21.9% since their peak in the second quarter of 2007.

The general lack of credit in the financial markets also has taken its toll. “Until you can really get your arms around debt, it’s hard to know the value of the assets because that is such a huge component in determining pricing,” says Steve Pumper, executive managing director with Transwestern in Dallas. “We are deleveraging an industry, and as a result that in and of itself immediately has a negative impact on pricing, coupled with the illiquid markets at this point in time.”

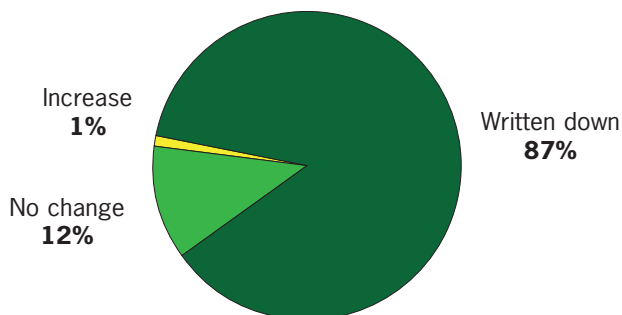
Due to the moving targets that make accurate valuations “squishy” at best, many pension fund advisors have the discretion to independently adjust property valuations based on their own internal metrics. “Some of the advisors are taking that tack,” notes Vorwaller.

For their part, many pension funds are making it easier on themselves simply by increasing their target investment allocations. Both the California State

COMMERCIAL REAL ESTATE VALUES HEADED SOUTH?

In a recent survey of the top 100 institutional investors, respondents indicate that their property values will be written down by an average of 8.3% during 2009.

Expected direction of change in value



Source: Kingsley Associates/IREI Research

Institutional investors get cold feet

Institutional investors, including pension funds, are more pessimistic about their real estate return expectations than at any point in the past 13 years. In fact, they plan to commit only \$29 billion of new capital to the industry in 2009, down 31% from the \$42 billion invested in 2008, a new survey reveals.

“On a risk-adjusted basis, real estate actually looks worse than other asset classes for the first time in several years,” says Jim Woidat, principal with San Francisco-based researcher Kingsley Associates. Kingsley conducted the study in conjunction with Institutional Real Estate Inc., a publisher and consultant in California.

In a difficult market for any investments, Woidat says pension funds will have to take whatever returns they can get. “Real estate is still the most attractive investment strategy to help get that cur-

rent yield they need to help fund their obligations, but there is great uncertainty whether investors will be able to hit their general 8.5% yield hurdle in 2009 and maybe 2010.”

The good news is that survey respondents did not expect to cut their target allocations to real estate in 2009. Real estate has averaged about 10% of institutional investors’ total investment portfolio in recent years.

“They recognize that especially in this low interest-rate environment their real estate investments, in terms of cash yield, are really important to meeting those obligations,” says Woidat.

Still, Woidat realizes that change is in the air and it’s not all for the good. “A big question is if real estate returns really disappoint these next couple of years, what does that mean in terms of their target

allocations going forward? Investors often look at past returns as they fine tune their target allocations.”

For now, pension funds and other institutional investors appear willing to maintain the status quo. But history shows that many long-term investors are not the best market timers. The California State Teachers’ Retirement System, for example, raised its real estate target allocation from 6% to 11% in September 2006, near the peak of the property markets.

Woidat worries that many funds may ratchet down their allocations just as new opportunities emerge. “That’s what we might expect to see, should real estate returns meet these very low expectations over the next few years when it will actually be the right time to put more capital out into real estate.” ■

— Ben Johnson

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— Ted Leary, founder, Crosswater Realty Advisors

Teachers’ Retirement System (CalSTRS) and the California Public Employees’ Retirement System (CalPERS) have raised their real estate asset allocation targets to compensate for the severe drop in the value of stocks and bonds. “This gives them a little more latitude to manage within a target allocation so they are not forced to meet an artificially temporary threshold and be forced to liquidate,” says Vorwaller.

Advisors under pressure

Pension fund advisors and investment managers are facing major challenges of their own in market conditions that many of them have never experienced. “Are the traditional consultants the right people? Do they have the right staff and skills to deal in a workout environment? Time will tell,” says Ted Leary, a 30-year veteran of the institutional investing business and founder of Crosswater Realty Advisors, a Los Angeles-based consulting company.

With investment activity slowing, many money managers are finding themselves playing a greater role as consultants. “It is clear to me from talking with both clients in the pension fund world

and from advisor friends that there is just a huge economic stress in the business,” says Leary. “They are learning that it’s a lot harder to fix deeply imbedded problems than it is to make new investments. We are slowly morphing, and it will pick up speed into where everybody is in workout mode.”

Many of the largest pension funds are trimming their reliance on advisors and investment managers, and finding it difficult to manage up to a dozen partners in some cases. “This cycle is going to force a dramatic shakeout in the advisory community,” says Leary. “Some of the more established managers will lay a substantial percentage of their employees off and a lot of the new managers that are small and less capitalized will disappear. We’re about to see who gets shaken out.”

Meanwhile, pension funds are more focused than ever on the performance of their existing portfolios. “The focus is not about new allocations; the focus is measuring projected returns and managing risk primarily within their existing commitment and investment portfolio,” says Mike McMenemy, global head of investor services at Los Angeles-based

CB Richard Ellis Investors, which advises nearly 200 institutional clients.

Backlog of commitments

Using a baseball analogy, Leary believes the commercial real estate industry is only in the second or third inning of the current cycle, with two to three years left to achieve recovery. Part of that recovery will involve deploying the pension capital that was already committed to investment partners and intermediaries to invest in 2008. With the use of even modest amounts of leverage, this dry powder amounts to hundreds of billions of dollars in ready and waiting capital to invest when the markets recover.

Ultimately, a more universal process of marking assets to market prices will best be achieved with increased transaction volume. “Most investors have the view that 2009 will be more difficult than 2008, but that more clarity will enter the market in the third and fourth quarters of this year,” says McMenemy of CBRE Investors. “The market signals will be the volume of assets that come to the for-sale market and the resulting price points of those early transactions.”

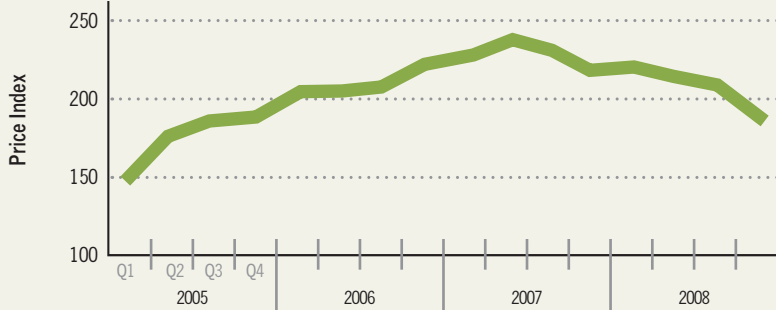
The early transactions will effectively set a pricing floor, narrowing the current bid-ask spread between buyers and sellers, adds McMenemy, and it will help shape investors’ return expectations.

Though armed with greater clarity on the pricing of their assets and ready-to-invest capital, don’t look for pension funds to be on the leading edge in shaping the market recovery. “The repricing of assets is just starting to happen,” sums up Pumper of Transwestern. “The perception is that patience will be rewarded. So why do they want to buy into a declining marketplace when they might have a better opportunity really in 2010 and beyond?”

Ben Johnson is a Dallas-based writer.

THE RISE AND FALL OF COMMERCIAL REAL ESTATE PRICES

A price index of institutional-quality, well-stabilized properties based on data from the National Council of Real Estate Investment Fiduciaries shows that pricing peaked in 2007 before dropping late in the year and falling further throughout 2008.



Source: MIT Center for Real Estate