

THOUGHT LEADERSHIP SERIES

*“State of the Industry”* Economic Discussion on Retail Real Estate with Peter Linneman

By Terry Montesi, CEO of Trademark Property Co.

Montesi: What can we expect from the national economy and the recovery? Where are we in the cycle?

Linneman: Basically 2% a year. GDP, we are basically adding about 2.2 million jobs a year. That puts GDP at an all-time high, both in absolute terms and in per capita. That is to say, real GDP has grown more than the population since the previous peak. However, in terms of jobs, we are at about 99% of the jobs we lost. From a labor market point of view, we are back to our previous high, but we have added a lot of people in the intervening six years, and that is why the unemployment rate is still high, even though a lot of people have dropped out of the labor force.

If you said we are in the fifth year of a recovery, that typically means we are in the sixth inning. I think we are in about the fourth inning. The reason I say this is, you have gotten ahead on a GDP basis by a percent or two per capita, and when you have got all your lost jobs back, you are normally only in the second year of a recovery; that would suggest you still have five or six years to go. A normal recession and recovery lasts seven or eight years, suggesting we are in the latter, not late innings. However, normally when you recover to previous job highs, and just getting a new per capita GDP high, you're really in about the second year. Also, we are about \$2 trillion below long-term GDP trend. Long term trend is nothing more than 2% productivity, 1% population. This is not anything new or complicated. About 80% of that \$2 trillion is nothing more than forestalled housing and auto markets.

The economy is not making inroads yet to the pent-up demand. Housing is nowhere near average. The point is that the pent-up demand is huge. Therefore, I think the more relevant benchmark is water level, where we have just got back to. We have just got our heads above water. We have not really started swimming forward yet. Normally four years into recovery, you have been swimming on the surface for some time, but in this case, we have just hit the surface.

Montesi: That makes sense. Have you thought about how much longer before the next downturn? You said we are in the second year. What would you call a natural cycle in the 21st century?

Linneman: I think normally you are looking at about seven to eight years. So normally you would say we are in the fifth of seven to eight. I think the truth is, we are in the second year of a seven to eight year cycle, so we still have five or six years to go.

Montesi: Let's talk about job growth now, your forecast and what that means to the economy.

Linneman: 60% of the country couldn't get out of their homes in the first three months of the year, so we are actually slightly behind where we should be. But we are going to get artificially high job growth and GDP growth. That is because... since I couldn't do anything in January, I forestalled that. I still think we will add about 2.3 million jobs this year and that is about the pace we are on. The housing market is losing momentum. It lost it because of snow and ice. So it had a temporary psychological effect. I think we will end up about 2.2 to 2.3 million jobs for this year. One of the other good things about the job formation is that it is increasingly helping lesser skilled people. The original jobs really only help higher-skilled people. As you get a better recovery in auto, and what I call normal people sectors, it makes the breadth of the recovery larger. I still think we are adding jobs pretty well. Not as robust as one might like, but we are making progress. We are back to just slightly under 100% of the lost jobs regained, which means a lot of places are quite robust, such as Texas. Some are still stumbling around.

Montesi: Can you give us the highlights of that? What are some places that have been healthy, and what are some of the laggards?

Linneman: Well, Texas is doing great for two very distinct reasons. One is energy. By the way, California should be doing well because of energy too. Places like Bakersfield are doing okay, not stunning, but okay. The second reason that Texas is doing well and California is not? Communist countries generally don't grow very fast, and capitalist countries tend to grow quite rapidly. Texas welcomes entrepreneurs, taxes are low, it is easy to build housing, cost of living is low, and the environment is extremely competitive. That is why Texas is doing well. If you ask where are other places that are doing well? Anywhere there's fracking.

Montesi: Comment on other parts of the country.

Linneman: Anywhere there's fracking. From a retail point of view, if you go any place near fracking, there is real dramatic growth. The problem is that most of them are very tertiary places. Having said that, real growth over a sustained period of time will continue. Interestingly, in the near term, more dramatic growth is in areas where there is oil. In the long term, more dramatic sustained growth is where there is natural gas. Beyond that, I say Florida learned a lesson and has improved. They had become a mini-California, and I think they have deviated back to trying to be Florida again. I think they have good fundamentals. Denver, Raleigh, etc. have very good growth fundamentals as well.

Montesi: Let's talk about interest rates and cap rates. Press says that quantitative easing is happening. Is that material? What is your forecast for interest rates for the rest of the year, and beyond that?

Linneman: There is no way anybody can say interest rates will remain this low forever. However, anybody who said that has been wrong for a sustained period of time, almost five years now. But, having said that, there is no way they can be this low forever.

Let's talk about quantitative easing. The Fed is still expanding the base money supply at about \$500 billion a year. This is after they have tapered to this point. In the fifty years from 1958 to 2008, they created \$700 billion in total. Now they are creating as much in a 12 month period after tapering as it took about 40 years to create. So they're still expanding rapidly. I'm going to try to round it in an apples to apples way – the first \$800 billion that the Fed put in the system, which was there as of the beginning of September 2008, generated about \$6 trillion in bank loans; not just to real estate, but all bank loans. And that is because of the fractional reserve system. Banks could lend more than the Fed gave them, by a multiple of about 7.5 or 8 times. Just think, \$6 trillion went with the first \$800 billion. Since then, the Fed has put \$3.2 trillion more in. So in the six years, five and a half years subsequent, they put \$3.2 trillion more in. That has generated \$500 billion more in bank loans. So instead of being a 7.5 to 8 multiple, it is a fraction.

Montesi: Why is that?

Linneman: Because banks have sat on it, they've not lent it. And it is probably because of the political pressure that has been put on them, and because of the stress test. They make stress tests better every day that they build up retained earnings, but it is an unparalleled moment in history. That means that banks right now – actually it is not banks, it is 12 banks – there are 3,500 banks who did exactly what they did in the past, and 12 banks that have \$3 trillion dollars against which they can lend at about 7.5 times. That is to say, there is about \$22 trillion dollars lending capacity legally available to banks that is unused. That is what the concern is about: what happens if banks start lending up to what they can do? How is the Fed going to stop that?

Think about this. There are currently about \$6.5 trillion dollars in bank loans, and they have the capacity to create an additional \$22 trillion. Put that in context. If they only create 15% of what they have the capacity to do, that translates to \$3 trillion dollars of new bank loans. That is a 50% increase in bank loans if all they do is lend 15% of what they're capable of lending. So you can imagine if banks start lending a lot, and the Fed tries to stop them so that we don't get rampant inflation, even if only 15% of it gets out before the Fed snuffs it out, you would have basically a 50% increase in bank lending. How would the Fed stop even more from occurring? They would stop it by raising the interest rate.

Montesi: Hasn't the Fed been paying the banks to do nothing by keeping the interest rates at zero so they can do very low risk things with that money and make a guaranteed margin?

Linneman: Except it would go from being hidden to visible. If banks start picking up their lending it would become more visible. As confidence occurs and more businesses clean up their balance sheets, as more consumers feel confident, and clean up theirs, they all have more incentive to borrow. They can't stop it by paying higher interest rates. The other thing they could do is, instead of buying bonds from banks, they would start selling instruments back. The Fed has been buying about 50% of all new federal debt through banks. Can you imagine what happens to an auction for something if the purchaser of 50% of it not only doesn't show for the auction, but they become a seller at the auction? Imagine somebody who's bought 50% of all the Picassos that have come on the market in the last four years, suddenly not only do they bid on Picassos, but they become a seller of Picassos. The price will go down. The price of government bonds will go down, which means the interest rate goes up. When it happens, how fast will it happen? Faster than we think. The question is when.

I don't think it is going to happen in the next six months, and that is because I think the political pressures not to do it are enormous. The Fed is not captured in that the government is bribing them, but the people who have been appointed to the Fed are believers. It is no different than the Supreme Court. You give me long enough to fill Supreme Court positions, and I'll get people who are all opposed to abortion. What has happened at the Fed – and the turnover is much higher at the Fed than the court – is that people who have been appointed are legitimate people, same as those at the Supreme Court, but if you pick them based on their position on this issue, you now have true believers. They are going to keep it down for probably another year or more, no matter what. That is what he picked them for, and he has gotten what he's wanted, but eventually it will have to reverse.

As to cap rates, I've been playing around with data, and as you know, cap rate data isn't perfect. I've been playing with REIT implied cap rate histories, and NCREIF's reported cap rates, both appraisal based and transaction based. None of these are perfect, but I'm going to summarize what I've found. First, there are eight episodes where interest rates have risen since 1996 by more than 100 basis points. In all of those episodes, if you come back 90, 180, and 360 days later, REITs have outperformed the S&P 500. In almost all those cases, REITs have performed positive. If there is an interest rate shock, given a little time, real estate will outperform its tenants.

Now let me come to the next part that I've studied. I've done very simple regression analysis. I don't want to overstate it, but it is better than I've seen anybody else do. Regression analysis of cap rates quarterly over the last 25 years, with all their problems, I looked at the effect of the ten year treasury, the effect of the flow of mortgage funds, the effect of GDP growth, the effect of interest rates changing, the effect of the unemployment rate changing, and the effect of inflation changing. The result is, yes, unemployment rates have an impact on cap rates, yes, GDP growth has an effect on cap rates, and yes, inflation has an effect on cap rates. Contrary to the pattern, the ten year treasury does not have that dramatic of an effect on cap rates. What overpowers everything, is flow of funds. Either direction, positive or negative flow of funds, if you get them, swamps anything else that happens; it overpowers GDP growth or shrinkage, unemployment growth or shrinkage, and interest rate movements.

Now, let's tie the conversation we just had. First, there has never been this much money lendable by banks, in history. Second, the CMBS market is growing. Third, real estate lending is at a cyclical low, down about 20% from its peak relative to the size of the economy. Do you have a hard time believing real estate lending would increase by 25% over the next five years?

Montesi: No, not at all.

Linneman: If you do a very simple simulation, and you say interest rates go up 200 basis points, and real estate lending goes up 25 basis points, and the economy grows by 5%, and unemployment falls by 100 basis points – by the way, none of that sounds unrealistic, right?

Montesi: No.

Linneman: Let's go back to a 50% increase in bank lending. If all they do is lend 15% of what they're capable of lending, real estate will get its fair share. What would happen if banks tried to really expand their loans? There is not that much more real estate. There would be so much money chasing the product, that liquidity is going to dominate other fundamentals. There is so much artificial liquidity; you don't need much of it to get out to be huge. Therefore, I feel better about cap rates not rising than I have felt for some time, because while I worry about interest rates, I think the flow of funds is potentially so great that it will overwhelm it.

Montesi: Peter, one thing that strikes me is that we have had this anemic recovery. A fundamentally sound economic infrastructure with huge pent-up demand in housing and autos. In our business, we've had no new supply built whatsoever, and you've got tons of liquidity in the banking system, and in corporate coffers. This tells me that if people get any sort of confidence in the folks in Washington, we could have a very intense recovery. Does that make any sense?

Linneman: Totally. That is essentially where I'm at. The only thing that I would add to this is that the flow of funds is beyond anything you and I could ever imagine, potentially.

Montesi: We have had this controlled, artificially low interest rate environment for a long term. In the future, we could also have an over-inflated economy for longer than we would have normally had to counter balance. Does that make any sense?

Linneman: Yes, I think that is right on target.

Let me give you one last comment on that, which is: While I'm very bullish in the way we just summarized, your views being the same – the fact that we are so far off, is that whatever confidence you or I might normally have in such prognostications, it is lower now than normal. Therefore don't take on as much debt as normal, even though it is cheap. Because if I'm wrong and we are in the late innings, and if I'm wrong and interest rates go up really hitting cap rates hard, something that looks like a conservative 70% loan could lose 20% in value quickly.

Montesi: So there is still more risk in economic forecasting because of this artificial manipulation of the economy?

Linneman: Correct. There is a very odd, skewed forecast, and the risk of being wrong is higher; therefore, you want more cushion and less leverage. Another way to think about it is, there is so much upside beyond your normal pro forma, because of the potential flow of funds and this untapped pent-up demand, that if they occur, irrespective of your leverage, you're going to make so much money it doesn't matter. Normally, you think of pushing your leverage to juice a mediocre upside. Here, you have a potentially stunning upside, so don't push your leverage quite as far, because you don't need it.

Montesi: One thing that is relevant to what we have done in the last six years, is that we are in the shopping center investment and development and operation business, and we've seen where there has been virtually zero supply added of multi-tenant space. Almost the entire construction has been for Costcos, Walmarts and free-standing grocers. Part of the reason I say that is the retail growth that has occurred in the economy and the population has gone online. E-commerce has basically taken that growth, and that is why retail has stayed flat. But from here, with this lack of supply and pent-up demand – what do you see happening in supply and demand in the retail business?

Linneman: The crude numbers – I think they're in this Linneman letter that I'm working on – over the last decade, basically half of all the real growth in non-auto, non-oil and gas sales, retail sales – everything I'm now going to describe, I'm not including automobiles and petroleum products.

Montesi: I'm with you. Real retail sales.

Linneman: If you adjust for inflation, that gives you a better look at things. In other words, how many jackets are going through, not are the jackets at a higher price, but are there more jackets going through? Of the real retail sales increase in the last decade, 50% is basically internet. So internet share is small, but incremental share has been very high. Of the growth, they're getting about half of the growth that has occurred. It is even trickier than that. If you take it from the peak of 2008 retail sales, we are only slightly higher real retail sales now than in 2008 because of the big drop, and we are just back. So basically, 100% of the increase in sales that occurred from 2009 went to the internet. Pretty stunning.

Now the good news is, traditional bricks have not lost sales, they just haven't gained sales. So you lost books, and you gained something else to stay neutral. The good news is, no new net supply means you haven't gotten worse off, but you haven't gotten better off. That is probably why the strategy of going to higher quality has worked for retail real estate for the last five years. If I told you that the throughput through bricks has been unchanged; you know that in some places it has been better and some places it has been worse. Basically, the higher quality tenants and markets have gained and the lower have lost. It is a very tough business model to

have work with no net industry growth. So over the last five years, you have had no net industry growth. It has all been online, which means there are true winners and losers because bricks have come out neutral.

Next, if you look at the share of retail sales that are going to clicks, it is been flat for about a year and a half now. I don't want to overstate the accuracy of the data, so you may look back and see other periods where it looked flat. One of the questions facing clicks, is at some point they've taken all the low-hanging fruit. I've always said that CD's were going to be the easiest. Why? It is a pure commodity; it is simple to ship, etc. And products with overnight delivery and returns are the worst. So, every time they take low-hanging fruit, the internet's had to go higher up the tree. And the question is how high are they up the tree at this point? My assessment of the last ten years is, in the beginning, they should have taken more low-hanging fruit faster than they did, but that is because so many of us didn't know how to use the internet. Then five years ago even guys like me figured out how to do it, and that just killed the low-hanging fruit. My feeling is, it's harder and harder to find low-hanging fruit. As you know, the overnight delivery with a lot of returns is a business model that can't work. It is too expensive. So I believe we are moving in a phase where actually, bricks are going to do better incrementally. That is to say, they may not get 100% of incremental retail sales, but they're also not going to get 0%.

Montesi: That was very helpful. Let's talk about institutional investors as they look at investing in retail. What are you hearing, as core has been so hot, are they starting to move up the risk curve in product type, B versus A, C versus B? Moving to smaller markets, etc.?

Linneman: Here's what I'm seeing: They are going up the risk curve, but their preferred way up going up the risk curve is leveraging the same stuff, higher leverage on the same stuff rather than moving down the food chain. There are two ways I can increase risk - one is leveraging my position in a very safe asset, and the other is going to a little less safe asset. I'm seeing investors – and not just in real estate – given the choice, especially at low interest rates, they are much more inclined to higher leverage on, or increased leverage as we move through the cycle, on lower-risk assets rather than moving down the food chain. Are they moving down the food chain? Yes, but slowly. If you have a development project in Des Moines, I'm not sure there is a lot more capital for it than there was two years ago. If you have New York City, 712 Fifth Avenue, 9 West 57, something like that, or an apartment equivalent, there is a lot more capital for it, but it is piling up in the form of debt.

Montesi: Okay. What is your perspective on investing in lifestyle centers and malls in B markets, or maybe even B malls and lifestyle in A market?

Linneman: If I'm going to the B metros, in light of what we were just talking about of internet sales and so forth, I think you do want to skew to better assets. There are two reasons. One, capital is not moving to the B. But even more so, even if I'm right, and retail does get 30, 40, 50% of the incremental rather than zero, there is still going to be a lot of leakage. And that means weak centers are going to be the ones that suffer damage from the leakage. It would be one thing if I could own all of the centers in America, but I can't own all the centers in America; I

own just mine. Therefore, if the leakage comes out of me, I can't take much comfort in saying, but somebody who has an A mall in another B market did okay. So I would gravitate to the best assets in B markets. B markets are not going to disappear. Nashville is not going to disappear. Even Cleveland is not going to disappear. So if I have the best assets in those, I feel quite good.

Montesi: Peter, is the retail business still a pretty bifurcated business?

Linneman: It is. Let's say the business model is retail sales growth, 3% real a year, throughput a year and the internet takes half of it – just for a number – incrementally for another few years. If I'm in a business that, in total, is only going to grow 1.5% a year, that means that there is going to be a lot of shrinking, even around a 1.5% average growth, because you know somebody is going to grow at 4-5%. If somebody is growing at 4% and the average is 1.5%, somebody's negative. While not as bifurcated as the last five years, it is still bifurcated. You can come down a little bit in your bifurcation though, because I don't think the internet takes 100% of the incremental going forward. You will get some positive growth. If you think of a bell curve, when you get down near a mean growth of zero, there is a lot of negative growth happening.

Lifestyle. I always was a skeptic of lifestyle centers. I remain a skeptic of lifestyle centers, even though you can show me six lifestyle centers that are huge, stunning successes; Easton and Coconut, down in Florida. But it still strikes me that lifestyle centers are a little bit like vertical malls, vertical retail, you can find some that work, but you can find a lot more that don't work. Everybody proves vertical works by Water Tower Place, but a block and half away on Michigan Avenue has been one that is dead as a doornail since it was built. I think lifestyle centers try to create a "Main Street", but if you look at them, they didn't really. If you think about what the mall did; the mall literally tried to create the old Main Street, of great retailer at one end, great retailer at another, and maybe a great retailer two blocks away in the middle, and then a bunch of small stores in between. If you look at how a lifestyle center is laid out, they don't lay out like old Main Street, they don't lay out like an old mall, they're kind of scattered, and therefore there is a lot of milling about, a lot of lost energy, versus a mall. So I think it is a challenged physical product. They do have lower CAM generally, which is a plus, but I think it is a bit of a challenge. The old downtown worked for a reason, and the mall copied the old downtown with high CAM costs, higher than downtown CAM costs. There are exceptions, but you didn't see old downtown look like the modern town center physically, of three blocks up that way, and two blocks over that way. Because when you try to intersperse all that parking and all that other stuff, it gets more diluted than the traditional downtown or mall.

A lifestyle center doesn't have the great retailer draw that the great mall does. It just doesn't. Generally, Chang's is the dominant retailer, or something like that. I think it is physically challenged. I learned real estate from Al Taubman, and the first lesson was the difference between retail and office. Retail versus other product categories is, if I buy office or I buy warehouse or I buy apartments cheap enough, I can cut the rent to a point where it impacts people's decision making to be there.

Montesi: It doesn't work in retail.

Linneman: It doesn't work in retail because no matter how cheap you buy it, you cannot cut your rent cheap enough to change the price of Cheerios. If you can't change the price of Cheerios, you cannot affect whether or not people shop there. That is a huge difference. Even if you get the center for next to nothing, and you set your rent at next to nothing, Cheerios are still going to be priced the same. Therefore, the customer doesn't really benefit much from the lower rent. So, that is a huge difference in retail versus the other sectors.

Montesi: I'll go a little more open ended: We are a retail investor/developer/operator, primarily we are Texas-centric, primarily in the community/center/lifestyle and mall space. What are other things we should be paying attention to? What are any other trends or any other risks out there, that should keep us up at night, or things we should be watching for?

Linneman: Well, let's start out by saying you had the good luck and the good foresight to be in Texas. It may be still a period where focusing on Texas is not the worst thing one can do, particularly on some niche development or some grave dancing you feel comfortable with. If I were to say a single trend, I'd look at areas like Marcellus & Utica Shale areas and say, should I go there, by doing a little grave dancing on something, and having a little staying power, as the drilling picks up? It is fundamental and long term. Williston is dangerous up in North Dakota. It is so remote and it is so oil-driven, that if oil goes below about \$77 a barrel, they just stop. I don't know that I want fixed capital in a place that could stop like that.

Montesi: That is what scares me about some of those shale places. They turn off.

Linneman: The dense places are much more robust. It is funny, they're longer term robust, they're not as near term robust. But they're economic for a lot longer. It is just that oil is so high that it makes Williston print money at current oil prices.

Montesi: Well, we didn't really talk about retail sales, do you have any commentary on what you see happening with retail sales?

Linneman: I think it is in line with everything we talked about with the economy. I see it in early innings. I think discretionary items pick up, and I think they particularly pick up in some of the more middle class, and not just the low middle. It depends how you define middle. Let's do it by income deciles. So far the recovery has been really good for the upper to middle third of the income distribution, maybe to the bottom tenth, because they're on welfare. It is that 20 to 30th decile. I think you see it just kind of filtering down a little bit, because of more home-building related jobs, more auto-related jobs, more normal-people related jobs.

Montesi: Yeah. So, as the economy gets a little bit healthier, the true middle is going to get a little healthier. We've picked up a couple of projects in areas like that, where they've been stable. They're in the \$300-\$350 a foot range, and we are going to go in and evolve those projects, improve them, bring them up to date, because as you know, retail has to constantly evolve. So you'd think that is a place where we could do some good here in the next few years.

Linneman: Yes

Montesi: Great. Thanks for your time. I look forward to seeing you soon.