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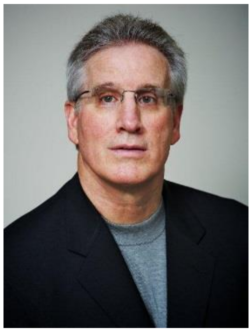

"Retail Property Outlook" Discussion with Peter Linneman

By: Terry Montesi, CEO of Trademark Property Co.

Montesi: Please update us on the U.S. economy. Where do you see it in the cycle, and how would you translate that as advice for us, and our friends?

Linneman: Sure. I would say, first of all I think one sign happened in the last few days. That sign is kind of giant deals, record-size deals. And while it wasn't a record-size deal, I would say the Blackstone/Wells Fargo/GE transaction. I don't think it kills all the canaries because it's not a record-size deal, but I think one sign of the coming end to the cycle was that transaction.

Montesi: So on the last bullet, we'll sadly mark out a canary?

Linneman: Yeah. There are still some there, right? There's still a lot in that category, but come on. That's a giant deal, and it means you have the ability to put together capital beyond the normal scope of deals. And it's well beyond the normal scope of deals. I thought that was, let's say in the last month or two, the most noteworthy thing in that regard - that's a lot of capital that was pretty instantly available for a huge transaction.

Montesi: And to be clear Peter, when a canary moves on, what that means is we might be in that one bullet, slightly closer to a bubble or a worrisome indicator?

Linneman: The end, you know? That's the way I would view it. Every time you see a canary go down, you're a lot closer to the end of the cycle. By the way, most of the canaries are still alive. Put it this way – kiddingly, but true – you take the canaries down the coal mine to see if there's dangerous gasses, right? And if they're all alive, no dangerous gas. And by the way, if you took a bunch of canaries down, one or two of them might just die of old age or a heart attack while you're down there. It could be a false positive in that sense. So, if you look at the two areas – I just viewed this Blackstone transaction, or the GE transaction not as a death knell, but it definitely killed the bird under that category, and it remains to be seen if we start seeing a whole bunch more record deals.

The other one was the Shell transaction. And while that was strategic, and wasn't real estate, and isn't record, that Shell transaction last week is a big deal. Again, you say, "Well, Shell has plenty of money. Yeah, and they're willing to use it." So, a canary has died on that. Most of the others I think are still in pretty good shape, but that's one where we may have seen one go down.

So if I come back to your big question, where are we? I still think we're in real good shape in terms of rent and occupancy; supply, demand, rent and occupancy. As you know, there's a lot more being built and redeveloped today than two years ago, when there was nothing. But yes, you guys are developing, and there are other people developing, but if I take retail as a good example, its more redevelopment than ground-up development, which is consistent with what your pipeline is. And redevelopment is not as destructive as ground-up development. Ground-up development is much more destructive to supply and demand balance than redevelopment. So, I'd say in rent and occupancy, we're still in the fifth inning, at worst we're in the sixth inning. I think we still have very good legs. Job growth, we added 132,000 jobs last month - that's going to be revised up. If you look at the other metrics, it's going to come out as one of those aberrant months that exists in data. We're still adding, I think, 2.8 million - 2.9 million jobs a year. If you look at other metrics like the labor market, new filings for unemployment and so forth, they're still quite healthy. So I still feel pretty good about the economy. I don't think the economy has run out of legs. I think it's got maybe three years, certainly two years of good momentum that it can maintain.

Capital markets are picking up speed. If you recall, I think the last two times we spoke, I told you I think you're going to just see staggering amounts of capital become available, and in the beginning that's healthy, in that we are coming off of an abnormal low in terms of capital markets. You're not seeing 90% loan-to-value, at least I'm not. You're not seeing that anybody can get a loan. However, that said, stuff that was getting 50% loan-to-values two years ago are pretty easily getting 70% today. I don't know about your projects. Two years ago you couldn't have done a development project even if it was a brilliant transaction because you couldn't have gotten the capital. Today, I suspect for your developments, you have several choices that were interesting if not unbelievable. Right? And for your redevelopments, I suspect you've found a good number of alternatives for financing that are reasonably attractive.

So capital markets are picking up. If you look at the data, you'll see a big upswing in corporate lending, and it'll be a notable upswing. I think it was in the last year, commercial real estate lending by banks swung from declining to expanding by about 8%. So not only has it stopped going down, it's picked up by 8% over the past year. And I would suspect that if we came back a year from now, you'll have seen that it's up by another 12 - 14%. So I think we're in the early phases of a lot of capital flowing. That's good for the moment, and of course sooner or later you get a lot of capital flowing - it's fun as long as it continues, but it eventually ends. The problem is that it ends after you got used to everybody wanting to lend to you, after which nobody wanting to lend is a big shock. I still think that's probably three to four years off on the capital market side. So I'd say supply/demand looks pretty good for say, two to three years before supply starts outrunning demand. And probably four to five years on the capital market side, before it's too late.

I think retail, just normal retail - I'm not talking Short Hills Mall, or best of best. You saw what happened to best of best with Simon trying to buy Macerich. The deal didn't go through, but if it had, would have been at near all-time low cap rates. But if you go to normal, pricing is not back to peak, but it's getting very close to peak. However, don't forget that peak pricing was six or seven years ago now, and at 2% inflation a year. Even if you're back peak to peak, it's still about 15-20% off adjusted for general inflation.

But I would think on your retail portfolio, you're probably 8% or so in the last year. I would think you're going to get another year well in excess of inflation. That is to say - let's say inflation is 2%, you're going to see retail up in the range of 4-7% in this year. That can't go on forever, but it's getting back to above average kind of prices, when you adjust for inflation. Remember when you talk about 2007, when you say, 'I want to get back to our previous peak, or 2008 previous peak pricing.' That, almost invariably, was an abnormal high. It wasn't like 2007 or 2008 were average years. So when we get back to that level, we're back to a real high level. Right now when you adjust for inflation, retail is right about average, by historical standards adjusting for inflation. I think it will go above inflation, as I say, in the next few years, but I also think there's a mean reversionary dimension, which means sooner or later it's going to drift back down. But that's probably four and five years off at this point.

Montesi: Let's focus on Texas. You had pretty strong opinions the last couple of years about Texas; its pro-growth and favorable regulatory environment. And then the impact of oil prices on the big economies of Texas – Houston, Fort Worth and Dallas.

Linneman: I don't know if you've had a chance to look at the new *Linneman Letter*. There's a pretty extensive discussion of the energy part, which I'll summarize. Let's stay with Texas, absent energy for a moment.

I like Texas. If you go the nine months that have transpired since oil prices fell, the job growth is bigger than those same nine months a year earlier. Which is to say, Texas is hanging on even as oil prices fell, and I think it's for all the reasons we discussed - low taxes, low housing costs… Easy-to-produce housing sort of keeps it competitive for workers, livable, all that stuff. That said, it's impossible to believe that oil prices falling as much as they have doesn't hurt Houston sooner or later. It doesn't mean it makes Houston go in reverse, but it's gotta hurt it, right? So I'm actually surprised that Texas job growth has been as strong as it has been so far. I would have thought it'd be about half of what it is in the last three months.

I expect positive job growth for the three cities that you mentioned. If you made me pick a number - half as much as a year earlier. By the way, half as much as a year earlier is still like a percent-and-a-quarter or percent-and-a-half growth, but it's not 3% growth. So I expect growth, but I expect slower growth. The good news is that oil prices fell just about as I think a lot of people were about to step on the development accelerator, and I think if oil prices had fallen maybe nine to ten months later, you would have found a lot more projects underway. So if oil prices had begun their fall today, I just think there would have been a lot more development started in the last nine months. You know, everybody looking at Texas as a developer hesitates as a capital provider now, versus the way they felt a year ago when oil prices were high. So the good news is I don't think Texas got way out ahead of itself on the development side. So if job growth falls but stays positive, it's not going to kill Texas in the way it would have if job growth fell and Houston developed like Houston normally develops. Or Dallas develops like Dallas normally develops. And I think you would agree, there's been relatively muted development, by Texas standards, in the last two years, even though employment's at an all-time high and job growth has been high. Development has been more Midwestern almost, right? There's development, but you don't drive around Houston and Dallas and San Antonio saying, "Oh, look at all the construction." At least that's not what I've seen.

Montesi: Yeah, I think you're right. It seems like the capital markets have required more discipline with lower leverage. I think the folks still have enough people around that have memories from the last two cycles, so there's been more discipline. But there's still a good bit of office and multi-family new development in both Dallas and Houston.

Linneman: Houston, I think, was really the one that got saved. As you know, on the office side there were a bunch of big firms that everybody was going after to anchor their development, and one of those has gotten started, but most of them were still in the talking stages. And to my knowledge, the discussions ended as oil prices plunged.

Montesi: Thank you for that feedback. Next, I would like you to help us think through the next five to seven years in retail development; retailing, which drives retail development; and where you see the investment and development opportunities in our retail and mixed-use business over the next few years.

Linneman: I think we talked about this last time. The biggest thing that's happened is that brick-and-mortar retail sales, as best one can calculate them, are not growing much; they're not falling either. They're growing a little bit, but only a little bit after you adjust for inflation, which means most of the growth in retail sales is going online - and I know everybody wants to do omni-channel. So essentially you have, if I had to stereotype the situation, you pretty much have the same goods moving through bricks as you did, let's say in 2008; you have pretty much the same stock of bricks as in 2008. Even though retail sales in real terms are higher, the real sales that are running through bricks are not, and I still think that's likely to continue for a while. And what it means is every dollar you take from somebody by renovating your property, every dollar extra sales you put into your property by renovating, somebody else lost. And that has not always been the case. For most of retail's history, brick retail history, there was two or three percent growth a year, which meant I could expand my supply by a couple percent each year, and I didn't steal anybody's sales. I didn't have to rob Peter to pay Paul. I think that has two implications for the business: one is, more defensive redevelopment will have to be done than we're used to historically. I think normally – and I'm on the board of a couple of large retail companies, one in Europe and one in the United States. What we've seen – and I've talked to others that've seen this – is that when you're renovating or upgrading your property, it's not that you're getting a spectacular rate of return on the incremental money; it's not like you're getting a 12-14% return on the incremental money. It's that if I don't invest, I lose, so the return I get is mediocre, 6, 7, 8% return, which is not exciting, but if I don't do that, not only do I not get that return, I could actually become a loser. So that's what I mean by defensive. I don't know how the math worked out on your redevelopments, but I would say a lot of them are not making returns. They're not just pure defensive, but they're mediocre rates of return considering the work you're doing.

Montesi: Peter, we have advised a lot of institutional owners and partners that, retail properties must evolve or die.

Linneman: So you're saying, exactly, that if you could get a 6 - 7% return on a redevelopment, your first blush is, 'Why am I doing a redevelopment if I'm only getting 6 or 7% return?' The answer is what you just said: 'If I don't, I could lose.' So I think that is a new pattern that's here to stay.

Montesi: Do you think part of that is a result of e-commerce taking the low-hanging fruit of the business? What is easy to do and does not involve this, since I'm comfortable doing online. So it means that we have to be a lot better at what we do just to maintain our relevance, as opposed to being able to sit back and just watch population and migration cause growth to the retailing business.

Linneman: I think that's exactly what it is. And at some point - and this is what's hard to assess - at some point, they're going to pick so much low-hanging fruit that there's not much there anymore. And it'll get harder to expand the online side of the business.

Montesi: That makes sense to me. Okay, next question. So if you were us, if you were our board member, what should we be concerned about? What things would you be watching for that might concern us? That's sort of two related questions in one.

Linneman: Yeah, let me take the first. Knowing from our conversations and looking online at your skill, what I would encourage you to do, is go out and find people who have, what I would call, institutional capital availability. So putting money into a property is not beyond them. You know what I mean?

Montesi: Sure. When you mention that we rarely have *really* thought about market share in our business - and we just recently had a strategic planning meeting, and it was one of the first times we really talked about market share. It was sort of subconsciously driven because there's not real actual growth in our business, but being 60-70% of our GDP, it's a big enough business to still make plenty of money in, but it's more about market share.

Linneman: I think in terms of, if you can find projects where you can get fees from repositioning using your expertise, maybe some part of the value improvement associated with it - I don't know how you structure your deals that way - I think that's a better niche than trying to go out… I like to find centers that are 80% strong, 85% strong, with a partner who's got capital, and convince them to work with me. Because there're a lot of ways they can work with me ranging from fee to JV. And a lot of the - what do you want to call it, mediocre centers - there's a lot of them where a fair redevelopment program can go a long way. And you don't have to leverage yourself to where you're out on a limb if a downturn occurs two years earlier than you thought it might.

Montesi: Yeah, that business you just described is a third of our business. It's the institutional, skin-in-the-game operating partner business. That is one of our three legs of our stool.

Linneman: And if you said as a board member, where would I be saying spend more of your energy? If that became half of your business, I wouldn't be crushed.

Montesi: Got it. And that's a great segue into my next question. Do you think it's a good time to be investing in our business? Because we're actually growing our company right now, and you can overthink things and become paralyzed by overanalyzing. So if you think about some of our development projects, if we start them today, they won't open for three or four years. The redevelopments are quicker. But because we're growing our market share, we're actually investing in human capital, etc. Do you think it's a good time to be investing in our business?

Linneman: I think it's an okay time. And I think you're probably about a year to a year-and-a-half away from when my gut says it's no longer a good time. My experience over my career is, when it looks like it's easiest to expand because there's a lot of business to be had if you just suck it up and hire the talent, it's a trap play. You know, it's the big pulling guard coming down; the line's going to clean you about a year and half later, two years later. I played defense, and I learned to look out for trap plays. You know - and I don't know if you ever played - but when you get across the line too easily, look out. And I don't think it's so easy to expand right now; you have to look pretty hard. I think when you don't have to look hard at all for expansion opportunities, stop expanding. I know that's kind of a wimpy answer, but if it's too good to be true, it probably is. When it looks like there are 38 great opportunities, and you say I can't believe there are 38 great opportunities, I have a feeling that four years later you will look back and say there were not 38 great opportunities.

Montesi: Yeah. I had lunch with a gentleman today, and I always tell him one of the things that strikes me, and could be a benefit of our brand growing and business going reasonably well, is that we can be pickier. And so in the past we've seen companies that thought, 'Oh, I just made a bunch of money developing a couple of centers, and I only have 10 people. Well if I had 40 people, I could do four times as many, so it's time to go hire 40 people.' And almost every time, by the time they get them hired and trained, you're at the end of a cycle and there's a bubble. So we're not thinking about that, it is a time possibly to be pickier. I think that's good advice. Don't get too carried away, right?

Linneman: And when, internally, everybody's saying we can't lose, that's when you're going to look back three years later and say, it wasn't the best of times, it just looked like the best of times right before the giant 300 pound lineman came down the line and blind-sided me.

Montesi: The blind side. That's what I said a little while ago. We all need Michael Oher on our blind side, right?

Linneman: And in our business, the blind side, there are two of them. One is the economy stops growing, and the other is, capital stops flowing. Either one of them can hurt you, and they both tend to happen at the same time. You know, you can go right back through past cycles where guys really geared up both in the leverage sense, and in the human capital sense, and 18 months later you're going, 'Holy cow. The world went from money everywhere and opportunities and a booming economy, to a shrinking economy and no money.'

Montesi: Good advice.

Linneman: The smartest deals I ever did were the ones I didn't do, in some sense. And you can't only live that way. But as you head into the times we're in, I'll give you one thing I watch, back to your earlier question. One thing I watch in that regard is consumer confidence. Consumer confidence is not a perfect metric, but it's not a bad one, especially for retail. Consumer confidence is now just back to average. It's slightly above average right now. Well, come on. Retail is not going to have bubbliness if consumer confidence is average. But you give me two or three years of above average consumer confidence, even though everybody looking at the data knows it's above average, it can't stay above average, right? It's going to have to revert, and when it does it hurts. So I would watch, as simple as it is, consumer confidence. And when I've seen consumer confidence above average for a couple of years, I'd get real worried in your business.

Montesi: That's great advice. Next, there's a third thing that I know you watch, and you and I usually try to talk about how it can shut things down. It's politics, and the lack of trust in our political system. Tell me where you think we are today versus - I remember four years ago or so that it was at the top of your list for why you were so troubled, and why companies were all hoarding cash because they didn't have any confidence that there wasn't going to be some new regulation that essentially stole their thunder. Where are you now, where's your head now relative to politics? Where's the trust level in the business climate?

Linneman: Quite low as it relates to the Fed. Because nobody, including the Fed can figure out what the Fed's going to do. And the Fed is important to what happens. So I'd say it's not political, but it's governmental. So on the Fed itself, I'd say quite low.

Montesi: Let's clarify, Peter. You mean trust is quite low.

Linneman: Trust is quite low. Or transparency of what they're going to do is quite low, and that's a negative. On the other hand you don't have to look now, but just make a note. Look at figure 60 in the new *Linneman Letter* that just came out. It's not my index, it's an index that's put together by a guy at the University of Chicago and another guy at Stanford; it's an economic policy uncertainty index.

Montesi: Great.

Linneman: Just like the consumer confidence index is arbitrary and not perfect, it still kind of picks something up. This index does as well. I didn't know about this index until about two years ago, and now I've started using it to track what I was talking about. You'll see that it's not perfect, but when you can identify some events that were quite uncertain politically, and times that were uncertain, the index is high. And when things look pretty low, the index is low. By the way, if you look at when the index is low there were periods of high growth, and when the index is high there are periods of low growth. So we've just gotten their index back to average. Again, almost like consumer confidence. So it's way down from way above, kind of record above average, as Dodd-Frank, and Obamacare, and all the tax swirling and so forth. It's down, it was briefly below average and now it's back to average. And I think it'll stay there through the election, because I don't think the Republicans can do much and I don't think Obama can do much, and as a result there'll be a lot of talk, but people tune out talk. And so I think we're going to be in a period of, for what, two years let's say, pretty low political uncertainty, which is a good thing; I think that bodes well for the economy. Then we'll see when we have a new President and another new Congress. But I think they're in a period where political uncertainty has receded; it's not low, but it's certainly no longer high, and I think a lot of the growth you've seen in the last year is reflective of - okay, Dodd-Frank's a shit law, but at least I kind of know what it means now. And Obamacare, we're slowly figuring out what it means. So I think actually from the standpoint of political uncertainty, we're in a good window over the next two years.

Montesi: That's interesting. I think it's worth commenting figure 63, which sits right next to figure 60 in your letter, is the small business optimism index. And those folks that are highly impacted by political uncertainty, that index is well up from the bottom, and the uncertainty index is well down.

Linneman: You know, we're both small business people. I did a study in 1979 on the mattress industry when they were putting in flammability standards. The most notable thing I found was, the mattress flammability standard had no impact on burns or deaths, but they had an upward impact on price. If you were a big manufacturer, Sealy or Serta, you got more from the price increase that was driven by the regulations than you got in cost increases associated with the regulations, and the small guys got clobbered. Yes, they got higher prices, but for a small guy to comply with all the regulations… The small business gets crushed by a lot of regulatory activity.

Montesi: Yeah, that was interesting. There's one thing I've followed and we've talked about in the past, and I would like your update on it. We saw a number of areas of our economy that had pent-up demand that if unleashed, could drive GDP from this sort of anemic, 2-plus place to 4 or 5%, which would seem like a boom compared to today. But it's really more average for a normal recovery. So I ask whether it's housing or corporate hoarding of cash - what do you see in those areas? Do you see pent-up demand still being there, and if so, where?

Linneman: Right. We have three things that were easily identifiable. They were housing, auto, and profits not being distributed. Profits are now being distributed, and that has dramatically fed the economy. So, that one is no longer there. Companies are making money and they're distributing it.

The second, auto, has made a big rebound. It's rebounded to slightly above average in terms of production. However, what they've not made up for is five years of way below average production. So that sector has made a recovery; it's doing pretty well. It still has a lot of upside though, because there is pent-up demand there.

Housing you know, multi-family has recovered almost exactly like auto. It's recovered, but slightly above average. It varies month to month, but let's say slightly above average. But you had five years of short fall, so there's pent-up demand. Single family, while it's up by over 50% from the bottom, it's still only about 56% of historical norms. I think the thing that's holding that sector back is down payment. And as I've argued, I think the Fed's policy of low interest rates has just punished peoples' saving to accumulate the down payment. Yes, if I have money for a down payment it makes my loan cheaper, but if I don't have money for a down payment, the Fed's low interest rate means I don't get any help from return on my savings. And it means I get no help from my grandparents. They won't help me because they're getting no income on their life savings, and when they're getting no income on their life savings, they don't give me a gift or a loan. I calculate that if interest payments are way down on debt, well, that means there's a whole bunch of people that would have received interest income. If 10% of the interest income that's been lost would have been spent on down payments for housing, you would have had housing at normal starts right now. It's a big number that's been discouraged.

Montesi: Very enlightening.

Linneman: By the way, if it would only have been 5%, there would be 300,000 more single family homes than are currently being built. So, it's a big deal. So that sector is still not chugging.

So two out of the three - profits are being distributed and auto is really chugging. A little bit of housing on the multi is chugging, but the single is still greatly restrained. And I'm convinced it's being constrained by the Fed's low interest rate.

Montesi: I love how you addressed the cost of low interest rates. You can't go a day where you don't hear someone talk about the benefits of low interest rates. Particularly in the real estate business, right?

Linneman: For every borrower, there's a lender. And those lenders are way disproportionately retirees. Just think of the traditional portfolio suggestion. You say well, retirees aren't buying a lot of homes. Fannie's studies show that about half of new home buyers get a transfer from that generation, historically. Well, come on. Suppose you have $300,000 life savings, you're getting

$1,000 a year income instead of $12,000 a year on your life saving. That's frightening if you're 84 years old. So when your granddaughter comes and says, can you loan me $10,000? If you're making $12,000 you might say yes, because you still have $2,000 after you're done. If I'm only making $1,000, I'm not going to give her anything. I think there's a huge unconceived impact in that regard on housing.

Montesi: Wow, that's really interesting. Thank you. My next perfect lead-in, it seems well choreographed when you hear it, so, we always have to ask you about interest rates and anything you see happening that might give us some guidance to what's happening there, where that's going, and then cap rates sort of follow. Do they really follow? Do you see anything indicating what might happen on that front?

Linneman: Okay. On cap rates, I don't think it matters much what happens to interest rates. As I've looked at it historically, statistically, none of the information's perfect, as I reflect on my career. Cap rates and interest rates are not terribly correlated. You can make theoretical arguments why they might or might not be, but the reality is, they are not terribly correlated. I remind people that in 2007, cap rates were quite low, yet the short rate was up above 5%, and the long rate was above 5%. So, you can have high cap rates or low cap rates without really correlating the interest rates. What cap rates really correlate with are flow of funds. That's why I think it's so critical that we're going to get a couple of years of big capital flows, and especially mortgage flows, and that will keep cap rates low. If you worry about cap rates, the value side, I'm not terribly worried about what happens to interest rates in terms of cap rates.

However, there's a second dimension, and that's a balance sheet dimension. Which is, should I buy long, or short, or whatever. And there, I'll give you a question I get asked a lot, which is why doesn't the Fed raise interest rates whenever we've had this low of unemployment and we've had GDP growing, or job growth, you know, the interest rate is never down at zero. Well, why do they hold it at zero and how long will they hold it? The simple answer is, they don't believe in markets, period. The Fed members do not believe in markets. Maybe they're right not to believe in markets. If you believed in markets you would say, from time to time for a short time, 'I'll intervene in the interest rate market, but generally I'll let the economy set the interest rates.' The Fed has very overtly said we do not trust markets, therefore, we're going to keep interest rates where we believe they should be. And that makes it hard to predict what will happen because you're trying to predict what people who don't believe in markets are going to do, where most of what we try to do is predict what markets will do.

So I think they're going to keep interest rates down. I think they're making a huge mistake, for the very simple reason they don't believe in markets. Therefore, if they're going to keep them down, lock long. If you're going to take out debt, lock long. We just took out a 12 year multi-family loan, so it's in a tertiary market. I'm being kind to call it a tertiary market. It's in a very tertiary market, and we took out a 12 year Fannie loan at 4%. No amortization for the first five years, because they view it as you would still amortize for seven years. I'll take that all day long. And if the interest rate goes down 100 basis points, I can live with it. Nobody's perfect. I've never seen a 12 year period in my life where interest rates stay really low. So, my view is go long. By the way, the other interesting thing, is there was something like an 18 basis point difference between a 7 year loan and a 12 year loan's rate.

Montesi: Wow. So what about cap rates?

Linneman: I just don't see that they're going to go up any time soon. I just think there's too much debt out there, and new debt coming in. And by the way, take the Blackstone example. There's a lot of private equity out there. It's supply and demand for properties; the demand is driven by capital. If there's a lot of capital, the demand stays high - the supply is not changing much; new development's not that big. Put it this way, if you think that the rate of loan expansion outstrips the amount of new development, cap rates can't really go up because the demand for property outstrips the supply of it. So I think that's going to keep prices up, cap rates down, for at least three or four more years.

Montesi: Thank you for your time, and I hope to see you soon.