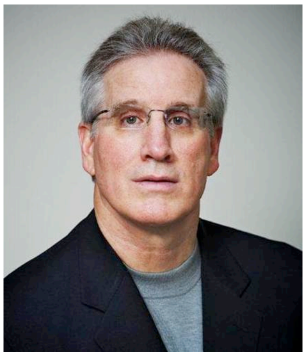
THOUGHT LEADERSHIP SERIES



"State of the Industry" Discussion with Peter Linneman

By: Terry Montesi, CEO of Trademark Property Co.

February 12, 2016

Dr. Linneman discusses the overall economy and the state of the real estate industry with Trademark CEO, Terry Montesi. Linneman is principal of Linneman Associates, CEO and Founder of American Land Fund, and the chief economist of NAI Global. He was one of the "25 Most Influential People in Commercial Real Estate" by Realtor Magazine.

Montesi: Give us your current impression on the global and US economy, and those factors influencing real estate and the consumer.

Linneman: I think the real economy, that is, jobs and consumer behavior and things that real people do day-to-day, is almost unchanged from anything I would have said two months or three months ago, which is solid, moving forward. Obviously it's been a lagging recovery, and still is. But it continues to recover. The numbers on jobs just came out and they were about 160,000. They'll get revised upwards to closer to 190,000 is my guess, based on ADP, private job numbers. That's too big a discrepancy, and also based on unemployment claims that are being filed, that's too low. It just doesn't pass the smell test.

Where there is a huge difference, even from six weeks ago, is Wall Street. Wall Street is very spooked. And if you ask what Wall Street is spooked about, they'll say China has slowed to 7% GDP growth. The dollar, on a trade-weighted basis, is up by about 20-25%. The Fed is raising rates, and oil prices have collapsed. Now let's just pause before we go back to Main Street, and

Wall Street is undoubtedly in a tizzy, there's no doubt. Spreads have widened, they're getting more difficult on loans, not just in real estate. Stock market's down. Treasury's yield dipped as if there was a flight of quality. It's a little reversed, but there was a flight of quality again. So there is no doubt that they're in a tizzy.

Okay. China's weakness. People have been saying for the last two years, expect China to continue to see a reduced growth rate, and it occurred - it came in at 7%, which was right where everybody has been saying it's going to be for two years. Why are they upset? Then you go one step further, you do understand that a 7% growth of China today is more economic activity being created than a 10% growth in China eight years ago, because it's a bigger base. And you go, I don't understand why you're in a tizzy, but remember that time you parked your car on a dark street and the streetlight was out, and you weren't in danger, but you convinced yourself you might be? I think that's what Wall Street is doing.

The strengthening dollar. It is up 25% on a trade-weighted basis over the last year or so, but the reason the dollar is up is because the rest of the world says we look strong. You go, why does that put you in a tizzy? Does it dampen exports of manufacturing? So it's not that manufacturing output is down, it's that the strengthening of the dollar reflecting the strength of the United States has dampened the demand growth for our exports, but it hasn't killed the growth of our exports. But it definitely has slowed it, so I don't get that.

Third, the Fed has raised rates from zero to 25 basis points. Any other time in history, if I told you the short-term rate, base rate, was 25 basis points, you'd say you've got to be kidding. And 25 basis points versus zero is effectively nothing. And by the way, you knew it was coming, they haven't raised it again. The uncertainty is there, but the rate itself means nothing.

Last is the price of oil. Oil prices have been down for a year and a half. And yeah, it's bouncing around and nobody truly knows where it's at. It's a little late to get worried about it. You say, well, companies are defaulting on their debt. We're real estate guys. Companies have defaulted on their debt all of history. And it works its way through with equity replacing debt.

When you go through the math, the lower oil price for the nation in aggregate is worth about 75 basis points of GDP growth. Now, not everybody gains. Those of us who had money in oil hedge funds, we lost. But, the lowest 30% of the income distribution had no money in hedge funds. They own no oil stocks, they own no oil bonds. And you know what they found? They spend 3% of their income on oil and gas products, and they've seen those products get cheaper. So yes, if you held oil stocks and oil bonds like Wall Street does, you might be shocked. There's a winner for every loser. But on the other hand, if you're America as a whole, you've gained. And this notion that they're not spending it is nonsense. All you have to do is look at auto sales. They're spending it on bigger autos. They're not spending it instantly, because they aren't sure how long-lived it is. If you look at the activity in Orlando and Las Vegas, you can see they're spending some of the savings that they've gotten on petroleum products going to Disney and Vegas. Both of them are up big since oil prices are down.

So I don't quite get why Wall Street is so spooked. Paul Samuelson famously said about 30 years ago, Wall Street being down, has correctly forecasted 30 of the last 4 recessions. And if you would've extended Samuelson's comment into the present, they've predicted 50 of the last 6 recessions. Which is to say, yep, it's been down all six times the economy was down, but usually trailing rather than leading. And then there's been about 45 times when it was down notably, and there was no recession. It's not a very good test. The fact that it is occasionally right; it's not even as good as a coin flip.

Now you go to Main Street. What do real people care about? Housing is still weak, but improving. There are more jobs in the housing sector. Home prices and home production are rising. That's good for the middle class, and for people who are trying to buy homes where there haven't been enough homes to buy.

Autos are a real part of the labor market, and it's quite strong, and it's a major product for people. And people are buying autos at very good levels. Real America doesn't care about oil prices being down. They love it!

Montesi: Or they work in Texas in the energy business.

Linneman: That's right. There are individuals in the energy sector, but they're not complaining as they're filling up, they're complaining as they go to work, right?

We're adding lots of jobs. Even if today's job number is correct, it's 1.8 million jobs a year. We're only adding 2.5 million people to the economy a year. And if 1.8 million of them are getting jobs, that's pretty good, if this is a correct number. So people are getting jobs.

By the way, do you know how the normal person on Main Street views the dollar being stronger? I can actually afford to go to Paris this year for my summer vacation. I haven't been able to afford Paris for years! Consumer confidence, which is a decent barometer of Main Street, is average, and moved nowhere. And recoveries do not historically end when confidence is average. The confidence is showing in retail sales. They're not stunning, but they're growing faster than inflation.

So, I think Main Street is right. There was finally a piece in the *Wall St. Journal* today saying the concern about deflation at the Fed is just nonsense. Goods prices are down, and oil prices are down, but service prices, everything we do: universities, medical, accountants, everything else we do is up.

So I think, I could be wrong, but I feel pretty comfortable that Main Street is right. This recovery has another two to three years of legs. The stock market is going to be jittery because of stuff. Remember, Wall Street is about fear versus greed, and 25 basis points matters to their bonus. Main Street is, do I have a job, and can I afford more things? 25 basis points, they don't even know what a basis point is, and they sleep well at night because they think Judge Judy is on the Supreme Court. And the guys on Wall Street don't even know who Judge Judy is. It captures the disconnect both ways.

Montesi: Okay, so Peter, where do you think we are in the cycle? A lot of people say we're in the 7th inning, and then the question is, are we in the 7th inning of a 9 inning game, or of an 18 inning game, more like Japan's?

Linneman: We're probably in the 6th inning of a playoff, or a World Series game. And the reason I say that is, there are much slower late innings in a world series. The commercial breaks are longer, they change more pitchers, etc. So this is going to be a longer game. A lot of people say, gee, we're in the 7th year, and a long recovery is 7 to 10 years. They're right. In a calendar sense, 7 to 10 years is a long recovery. But if you look at how many jobs we've added from the last peak, how much retail sales have grown from the last peak, have we added debt from the last peak, where consumer confidence is at. We're kind of in the 5th and 6th innings by those metrics. The only metric by which it's longer, is months. And I think months are less relevant than the psychology of exuberance and overinvestment. So I still think we've got two to three years easily to go.

Montesi: I'll tell you a very quick story. I was at an ICSC trustee meeting last week, and they had a really good capital markets panel, and the majority of the folks on the panel thought that in the next 18 months we would enter into a mild recession. You don't agree with that. Why are a lot of people more nervous today than they were 6 months ago?

Linneman: They're strictly measuring it by time.

Montesi: You mentioned that may be because they're viewing the stock market…

Linneman: They're viewing the stock market as a predictor. And it's just not. I'd say a coin flip was a better predictor. That was Samuelson's point. You can out-predict Wall Street with a coin.

Montesi: That's good color. One of the things I hear is, don't spend too much energy trying to predict the end.

Linneman: I think that's right. I think that's the right way to view it, I really do. Watch consumer confidence, and if you start seeing that down a couple of months, get worried. I mean really down. Really dropping notably. A couple of months, then get worried. You're not seeing that…

Montesi: To follow up on that, should we be taking the same risk as a year or two ago? Any advice? Help us understand your view on risk profile and what's appropriate for somebody that does what we do.

Linneman: Time specific risk, I would avoid. By that I mean I'm going to buy it, fix it up over the next 18 months – by fix it up I mean leasing, I don't just mean physical – but I'm going to buy it, take 18 months to get my work done, and then I'm going to flip it. That's what I mean by time specific risk. Because if you're wrong, you could get hung out when you want to flip. This is not a good time to bet the ranch on timing. The interesting thing is, the time to bet on timing tends to be early in the cycle, and that's when no one's willing to do it, right?

Let's just take what we were saying. By the way, if I can flip it, that's great, but I'm also capitalized such that, if I have to wait an extra three years, I can see myself through on cash flow, I'm not going to violate covenants, I've got coverage even if my cash flow takes a hit. I think you want to start hedging, you want to, from a risk point of view, be in a position where timing is not what it's about.

Montesi: So it makes sense that we should focus more on quality and be more conservative with leverage.

Linneman: Yes. And I'd be longer term on my leverage. And of course it's tempting to do the exact opposite, right? You just don't want to bet on it.

Montesi: That's great. So, in your view, is it still a good time to be harvesting?

Linneman: In a general way, it's a great time to harvest, especially stuff that you don't want to have three and four years from now, five years from now. Yes, I think you can get some income increase on those over the next couple of years, and I even think the cap rate, more or less, will hold over the next couple of years. But if it's not stuff you really want to hold, why take the time risk? So, if stuff that you really want to hold and operate, 5, 6, 7, 8, 10 years, it's too hard to find quality, I wouldn't be selling it.

Montesi: You mentioned cap rates. You just said you don't think cap rates will move a lot in the next couple of years. Give us just a little more color on your assumptions and why you stated that.

Linneman: I've written about that over the last couple of issues, and here's the short answer: If you look at the data, you really don't find any relationship between either REIT cap rates and long interest rates, or NCREIF, the kind of so-called private cap rates and interest rates, even using NCREIF's transaction data. You just don't find any relationship with interest rates, ten year treasury rates. What you do find a relationship with is, how fast do commercial and multi-family mortgages grow relative to the economy. And if commercial and multi-family mortgages are growing a lot faster than the economy, cap rates fall. And if mortgages outstanding are falling relative to the economy, you see cap rates rise. And if you think about the world as you've known it, flows of mortgage funds determine cap rates, interest rates don't. And I always tell people, go back and look at what interest rates were in 2006 and 2007. Cap rates were almost identical in 2006-2007 to what they are today, and both the short and the long rate were 5%. How was the cap rate able to be what they were in spite of high interest rates? That's because there was mortgage money flowing a plenty. Why did cap rates skyrocket in 2009? It had nothing to do with interest rates, it's that lenders disappeared, and mortgages outstanding fell. Flow of funds fell, you're in a capital intensive business, and cap rates go up. It's all about flow of funds, not interest rates.

People then say, well how can that be? Because if interest rates go up, the cost of borrowing must go up. That's not true. If you go back and think about history, as interest rates have gone up, lenders have wanted to put out more money. Higher price, higher return - they want to put out more money. How do they get you to take more money? They give you a higher LTV, and reduced covenants, and interest only. They give you situations where the spread is narrower. So, yeah. The interest rate goes up 200 basis points, the spread falls 120, the loan to value goes up from 70% to 80% on the first, so you don't have equity filling that 10%. And when you do the math, it's unchanged, your cost of debt, you know? And if anything, it's lower.

Montesi: But your risk increased materially.

Linneman: Your risk is higher, it's only higher if you take it, right? But remember who's establishing the cap rate. Let's go back to what we were saying. You look at it and you say, you know, I don't want an 88% loan. It's cheap but I don't want it because if I go down, I don't want it. So what do you do? You find that somebody comes along who's willing to take 88% debt and buys you out. That's what's setting the cap rate. So you get lower leverage buyers being replaced by higher leverage buyers, but their weighted cost of debt is unchanged. You're right, the equity risk is different, which is why you tend to get a lot of transactions occurring when there's a lot of flow of funds, namely, the lower leverage guys look at it and say I don't want the risk, and they just get outbid by higher leverage guys willing to take that risk.

Montesi: It seems from what we've seen and heard, the last 60 days or so, is that lenders are tightening up some, which would possibly indicate that cap rates might move up. Do you think that's temporary?

Linneman: I think it's temporary. When you look back at spreads, and you look back at lending activity, there are hot periods and cold periods. But when you look back, you forget. Three years from now, you forget January was a tough month. That's what I think will happen. In particular CMBS lenders have tightened over the last month, but remember that the dominant source of lending is not CMBS. The dominant source by far is banks. And yes, I just got a quote where the bank had increased the spread by 40 basis points, and the interest rate had fallen by 36 basis points, so it was a 4 basis point increase on my quote. And by the way, the same proceeds, etc. That's rounding error, right?

Montesi: You need to find another deal.

Linneman: Yep.

Montesi: So let's talk about retail, the consumer, and the retail real estate business. Let's zero in on your comment, your view about retail real estate and the consumer.

Linneman: Retail continues to grow. The consumer's continuing to buy. It gets harder and harder to know if they're buying it virtual or bricks, because more and more brick retailers also sell virtual, and you don't get a real breakdown of the numbers. It's harder and harder to know how much of the retail dollars are brick versus click. I'm on a retail board - all we can identify is our customer sales are increasing in the stores. Are they increasing massively? No, they're probably outstripping inflation by about a percent, but real throughput is up.

The interesting thing about click sales is nobody's ever made money on it. Amazon's never made money. Now, they've made money on particular sub-segments. But as a retail activity as a whole, they've not made money. By the way, Macy's doesn't make money on its online retail sales. And you go, okay, that's odd. Here's a segment that's probably got 10% of all retail sales, and no one has ever made a dime on it. And, the only reason it's able to continue is that it's like drilling an oil well. I'll eventually hit oil. And as long as the capital market says we'll let you keep drilling, you keep drilling, right? And that has been online sales.

If online sales had to make money in the normal way a retailer makes money, they would have to raise prices by 20 – 25%. And if they did, their sales would go down enormously. So it's hard to know how deep online can hit bricks, because the minute the markets aren't willing to subsidize it, it will stop. It won't disappear, it'll stop and re-trench a bit. There was an interesting study I believe Macy's did. Macy's loses money on online sales, but if they can get the customer to return it to a Macy's store, for every dollar returned, they sell $1.40. So the way Macy's has figured out they can make money on online sales, is if the return rate is really high. But if instead of mailing it, if they can get people to drop it at the store, they pick up incremental sales and traffic.

Montesi: At the trustee meeting, Peter, we talked about this, and it seems like a conclusion is that online is a less expensive place to start up a prospective retailer, if you will. But if you're ever going to really make money, you're going to end up going bricks and mortar like a whole lot of them are. Or if you're already a bricks and mortar business, not a startup, then online is a sales and traffic driver and a necessary customer engagement tool. Does that make sense?

Linneman: It's almost like coupons in a funny way.

Montesi: So you have to be engaged with people who are living on their smart phones, and if you do it well, you can drive sales and traffic. Does that make sense?

Linneman: It makes sense to me. In a funny way it's almost like advertising, right? Advertising, per se, loses money, right? I pay for the advertisement, and then I hope they come. And in a funny way, I think online sales fit that. It keeps my brand in their mind, my product in their mind, my store in their mind. And, I sure hope they return it in person. And why do I give people coupons? I hope they come to the store to redeem it, right? If they can come to the store and redeem it, I'm going to make money on the other transactions. Nobody just comes in and just buys a bottle of shampoo that they have a coupon for, they also buy stuff they don't have one for. I think that's the right way to view it.

Montesi: That's a great analysis. The last thing specific to retail: Regarding growing value, the last 6 years, 7 years, we've had cap rate compression - it has really been responsible for much of the growth in values, but the other way is increasing income. So do you see any catalyst for rising retail rents over the next few years? Do you think it's going to be pretty flat and it's going to be all about operations, etc.?

Linneman: The only catalyst that I see is that new supply is very limited. And therefore, you don't build spec, and there's very limited – by historic standards, retail construction. Offices bounced back, hotels have bounced back, apartments, industrial bounced back. Retail construction is still very low. That's the only "catalyst" other than just economic growth a bit in excess of inflation, right? But the one that you could get some catalyst, particularly on better centers, is there's no place else to go, and no one's going to build one for me, because yes, I can be their tenant, but they need 12 other tenants, and it seems hard to scare up 12 other tenants for a new development.

Montesi: That would tell me to focus on quality.

Linneman: Absolutely. Especially in retail, of all the properties. You know, I learned real estate from Al Taubman. Tough guy, but he was wonderful to me. I remember one of the first things he told me, was you can buy an apartment building cheap enough that you can lower your rent to the level somebody will move there. And you can buy a warehouse cheap enough that you could lower your rent to the level that somebody will store a box. And you can buy a hotel cheap enough that if you run it well, you can set your room rate low enough, somebody will come. With retail, even if you buy it cheaply, you cannot set your rent low enough to affect the price of Wheaties. And if you cannot affect the price of Wheaties, no one is going to come there just on low rent. They've got to sell more Wheaties.

Montesi: Yeah, so if you think about that from a macro standpoint, then what you and Al would advocate is that retail, of all the real estate food groups, is the least price-elastic, and most location sensitive.

Linneman: Location, and operational. By operational, I mean, can you put together three killer tenants. Imagine you've got a location where the three killer tenants shouldn't be, but you somehow got them there by hook or by crook, and they're going to be there another 20 years, you're powerful, right? And so, it is about retailing. And retailing is about location and mix. It is a special product.

Montesi: Next, I need to go to Texas. So, $30 oil, you've talked about who that's good for. Let's talk about who it's bad for. How bad. So your forecast and view on Texas, on Houston, on oil prices, and if you have any point of view on the oil price cycle, if you'll weigh in on that.

Linneman: Let's start with the world the next year or so. Houston. Dallas has been affected, but less so. Dallas was growing jobs at about 3 to 3.5%. It slowed about 50 basis points. Much broader economy, though it does have some oil exposure. Houston, much higher oil exposure. Went from growing at about 3.5% on jobs while oil prices are up to about .8%; .5% to .8%. The way I view that is very simple but, think of Houston, largest medical complex in the United States, keeps growing. Not sensitive to oil prices, keeps growing. Medical is growing at the same rate it was before oil prices fell. Oil is the other big sector. And it went from growing to shrinking. So now you take, instead of – let's say they both were growing 3.5%. I'm just being arbitrary. So both of those sectors, 50% of the economy, each were growing 3.5%, so Houston was growing 3.5%. Now you still have medical growing at 3.5%, but you now you have oil contracting at 3%. Now you do the weighted average, and you come with a small positive growth. And by the way, that continues as long as the oil sector is adjusting. At some point, the oil sector – and I think that sometimes is within the next year, they've rightsized. Much smaller than they were, but they've rightsized. Once they stop going negative, you'll see Houston growth pick up, because it's still Houston. Namely, low taxes, very affordable housing. Decent weather. And quite entrepreneurial.

So, what you've got is an adjustment period, and it is wiping out almost all of the growth in Houston, even though the medical is still growing. When oil just goes to zero growth, which it will at some point – it's not going to disappear because the oil price is at $30 – it's just going to downsize, then you'll go back to seeing growth on the range of 2-3% in Houston, which by standards of any normal place is high. That growth will be more driven by all the other sectors, if you will, than oil. It's driven by entrepreneurship. It's driven by low housing prices, and so forth. Low tax rate.

What about oil prices? All the math I've done, and all the math I've seen done, basically says you broke the cartel when the U.S. added a billion barrels a year to its production by fracking. And the cartel could no longer keep prices up, then saw the price plummet to somewhere near where we can produce. It turned out that fracking – people thought that the break-even was around $60. It's now looking like it's more in the range of $30 to $45. And therefore, they can't push it much higher than that, or people just poke holes in the ground. And the IRR needed for fracking is pretty low, because you get so much recovery in the first year or two. It's not back-end loaded, it's front-end loaded. The reason, technology improvements and labor costs falling as have reduced the break-even. If you're Saudi Arabia, and you saw the price go from $100 to $30, you cut production? No way. You need revenue. You increase production. And they need to cut production to crush us. And if they cut production, the price will skyrocket, and we'll just flood it with fracked oil at $40 a barrel, and so they're in a very odd situation.

Here's the real question. Remember when you first heard about fracking, people said it's going to change geopolitics. This is what they meant. You're now seeing what they meant. Because it breaks the cartel. Saudi Arabia makes money as long as the oil price is above $4 a barrel. The problem is they need $90 a barrel, or the revenue of the old output times $90 a barrel. They need the multiplication of the equivalent of $90 a barrel of old output to bribe their people not to revolt. Said differently, they know their people don't revolt at that revenue. So what we're now about to find out is, including Russia, roughly a billion of the people of the world, one out of every seven people in the world, live in countries that have been bribing their people not to revolt, based on oil prices well above fracking break-even. And the question is, will those people rebel at prices of $40, $30 a barrel. And how much can they increase production in the short term to make up for the price fall by quantity increase to keep their people from rebelling? Nobody knows when Saudi

Arabians rebel. Nobody knows when Venezuelans rebel. But we do know there's a whole bunch of countries that have bribed their people not to rebel. That's what it means to say geopolitical risk and it's bigger than I can figure out, so to speak.

Montesi: And Peter, it sounds like, when you think about the new return paradigm from drilling, and that with technology you can make money at lower oil prices in the US, that we might be settling into a 35-$60 a barrel sort of zone, long term.

Linneman: That's where I come out. The math that I've got going off the top of my head – there's a chart in Linneman Letter that shades the range – best I can figure out from the best analyses, somewhere in the range of about $24 on the down side, to $50 on the upside, is where it's going to be, because if they try to take it above that, you poke a hole in the ground, and you get a 12% IRR with 80% of your money back in the next 2 years. And the only reason the range is so big, is you don't quite know how much volume is involved.

Montesi: Great. Two questions: one, is it worth you commenting on the election, and if somebody wins, does it release some pent-up demand? And then the other is just a closing parting shot: if you were us, is there anything you'd be focusing on from an opportunity standpoint, or staying away from?

Linneman: I'd stay away from, "At this price how can I resist?" I'd stay away from that. I'd focus on, "This is stuff I want to hold, even if I have to hold it 7-10 years. I'd be happy."

On the election, it's an important election in that we have gone now 15 years with a government that believes the government knows better than the markets. Interestingly, Bill Clinton did not believe that. He talked differently, but if you actually looked at what he did, he actually believed in markets.

Ronald Reagan believed in markets. Jimmy Carter did not believe in markets. Nixon did not believe in markets. George Bush the 1st did not believe in markets. When I say believe in markets, relative to governments, put aside their rhetoric, but their actual behavior. And neither George Bush 2nd nor Obama believed in markets. You can argue Obama's probably been, since Jimmy Carter, the one who's believed the least in markets, and it's not surprising we've gotten the lowest growth.

So it's an important election in that we desperately need an administration and a Congress that believes that markets are better than them, and in that sense, it's an important election. I can't figure out who that party is. I know it's not Bernie Sanders. But I can't figure out among the rest of them, including, by the way, Hillary Clinton. And I'm not a Hillary Clinton fan. But, in terms of 'does she believe in markets,' I go back to the fact that Bill Clinton's behavior believed in markets. He brought in Bob Rubin. He brought in people who basically believed in markets. George Bush did not. So, we desperately need it. I can't quite figure out among these people running who truly believes in markets as opposed to rhetoric.

My last statement I'll leave you with is, it can't be worse than the last 15 years.