LaSalle Investment Management

*Recently, **Geoffrey Dohrmann**, publisher and editor-in-chief of* The Institutional Real Estate Letter – North America, *spoke with **Wade Judge** and **Bill Maher** of LaSalle Investment Management. The following is an excerpt of that conversation.*

We're two years into the recession now. How are things looking for investors in the U.S. property market today?

Judge: It depends on which side of the investment you are standing. Given that values are still falling and vacancy rates are still rising, it is a very difficult time to be an owner of real estate. If, however, you are a prospective buyer, it is starting to look quite interesting. Yields are up much further than they were a couple of years ago, and prices on well located, fully leased, core properties are the lowest they've been in decades. Today, the big question is: where are rents and vacancies going? Accurately forecasting demand over the next few years will be crucial to successfully underwriting new acquisitions.

Maher: Investors are also concerned about finding the bottom. Nobody wants to get in too early, but I think we're just about there. We may have another 5 to 10 percent decline, but I believe most of the revaluation has taken place.

How do various regions of the country differ?

Maher: There are enormous differences. I'll start with the strong markets, of which there are only two — Washington, D.C., with all the federal expenditures, and Texas, which benefits from being an energy state and having low costs. It really never had the run up in pricing that other markets had, and it still has the best job growth of all the states in the country. So those are the two good markets — the rest are in various stages of weakness. Some of the hardest hit ones are the markets that relied on residential construction to drive their economy, such as Phoenix, Las Vegas and parts of California, particularly the inland parts. In addition, the U.S. auto manufacturing markets have been hit hard.

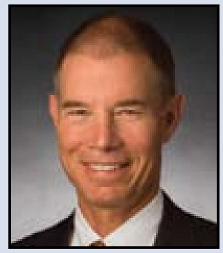
We keep hearing that buyers are waiting for distressed assets to come to the market, but that distress doesn't seem to be materializing. Are sellers just going to hold on and make real estate a long-term hold again?

Judge: It all depends on an owner's capitalization status. Where there is real distress is where there is a lot of leverage. If you have no leverage and you are committed to real estate, as most of our clients are, you are going to hold on. There is nothing that is forcing you do to something that is detrimental to your portfolio. If you do have a lot of debt that is maturing in the next year or two, and it is something other than multifamily debt, you may be forced to do something that you really don't want to do. In many cases, the easiest assets to sell are your best assets. That may not be what you want to do, but it may be what you have to do to raise capital to pay off the debt on that asset or, more likely, the debt on another asset.

Maher: We also haven't seen a lot of distress yet because most of the debt maturities that are likely to lead to those sales aren't due until 2010-2012. So there hasn't been a lot of pressure yet to cause a systematic number of sales — but I think that's coming. Transaction volumes increased slightly in the 3rd quarter, the first rise since mid 2007.

What do you see happening with the CMBS debt that is out there?

Judge: That is probably the number one question I hear in meetings with clients or any folks in the real estate business, and I am not sure there is a really good answer. It is going to take a public response because, given the complexity of the situation and the enormity of the situation, I am not sure it is going to resolve itself in any kind of tidy fashion.



Wade Judge, international director and chief investment officer of the U.S. Private Equity business, is the chairman of LaSalle's investment and allocation committees. Prior to assuming his current responsibilities, Judge was responsible for directing the acquisition group's office, industrial, retail and residential investments activity throughout the United States for 10 years.

William J. Maher is the director of North American investment strategy. Based in Baltimore, Maher develops real estate investment strategies for pension funds and other institutional clients and provides research and strategic advice to LaSalle's Baltimore-based real estate securities group. He serves on LaSalle's North American investment committee, which oversees investments in Canada, Mexico and the U.S.

CORPORATE OVERVIEW

LaSalle Investment Management is one of the world's largest real estate investment managers, with approximately $36 billion of assets under management. LaSalle is a wholly owned subsidiary of Jones Lang LaSalle (NYSE: JLL).

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Maher: We are looking at this very carefully. There is $623 billion of CMBS debt maturing over a nine-year period. 2010, 2011 and 2012 are three of the higher years, and regulators have provided greater flexibility to extend and restructure loans. This is a new product since the last real estate recession and it has not been tested in a downturn, so there is great uncertainty. I think it will play out over a fairly long period of time but at some point the senior debt holders will look for repayment.

So what would you be telling investors? Is this the time to invest, or still a time to sit back and wait?

Judge: This may not be the exact right time, but the right time is quite near at hand. Sometime within the next several months there are going to be very, very outstanding investment opportunities.

Maher: And even then if you had a fair amount of money to invest, you wouldn't put it all out at one time. This will play out over a number of years, particularly as the debt needs to be restructured.

What kinds of strategies are you putting together for institutional investors?

Judge: Right now, core investments stand out. In this climate, it is much easier to retain tenants than to attract new ones, so owning a fully leased asset has big advantages. Core assets, by definition, also contain no or low leverage. Because debt is very difficult to obtain, investing in low-leveraged assets makes a lot of sense.

Maher: There will be great returns from value-added and opportunistic investments, but the risk level has gone up, and it is harder to underwrite new acquisitions and deals in that space. Core will be a little bit more predictable. With core, you are getting above-average returns and the risk levels are not significantly different than they have been over the long run, whereas the risk level of value-added and opportunistic strategies has gone up a lot.

How will you know a good deal when you see it?

Judge: For core properties, a good property is determined by the quality of market, location within the market and the rent roll. For it to also be a good core investment, we will be looking at financial metrics like income return, IRR, price per square foot and price relative to replacement cost. Core properties with going-in yields of 8 percent to 10 percent, an unleveraged IRR of 10 percent and at a price below replacement cost would represent "a good core deal."

Maher: I would agree with that, but as we said at the outset, values are down, somewhere around 40 percent. We think they are close to the bottom, and that alone is going to provide some very good investment opportunities. Forecasting cash flows will be difficult given weakness in the property markets, so it will be important to have a view as to which markets are most likely to recover and thrive over the long run.

What types of returns should investors be expecting?

Judge: We went through a period of time when core investments were obtaining unleveraged returns in the 20 percent range. That was obviously unsustainable. Core real estate is not going to achieve returns in the 20s again. However, over the next few years, we believe it certainly should be possible to achieve returns of 10 percent or more. Over the longer term, returns should settle back into the range of 8 to 10 percent.

Maher: We have a lot of research showing that core real estate returns should fit between stocks and bonds, and 8 to 10 percent makes sense, given the risk levels and the different liquidity levels compared to other asset classes. It is cyclical, so it will go above that and beyond that at times, but over the long-term, that is what we advise our clients to expect.

Are you finding that you need to reeducate some of your pension fund clients on the proper role of real estate in a portfolio? Over the past few years many of them used real estate to boost returns.

Maher: Many investors shifted heavily into value-added and opportunistic investments, and they really moved away from real estate characteristics — which are basically focused on steady cash flow — to more of a highly leveraged capital market play, which is a different investment style. They are now coming back to the realization that if they can get an 8 to 10 percent return over time without adding risk, that's a good investment strategy. After the past few years, investors are putting greater value on stability of returns. Investors will still have some riskier strategies in their portfolios, but they will probably be a smaller part than they used to be.

Judge: Most of our clients are committed to real estate; they think it does have a place in their portfolio. In fact, several of our real estate clients are looking at slightly bumping up their real estate allocations, as opposed to taking them down. They are, however, looking to have less risk than they might have had a few years ago.

Are investors focusing on the income component rather than the appreciation?

Maher: Most investors are looking for both income and appreciation. They are looking for income to match pay-out liabilities and stabilize overall portfolio performance. Over the next few years, investors will be hopeful that current low values will appreciate as the markets come back, but there has definitely been a shift towards income.

You mentioned that some investors are increasing real estate allocations. With so few assets on the market, how are they going to commit increased capital?

Judge: Right at the moment, investors will be hard pressed to see their actual allocations go up because of the few transactions that are being consummated. But these are forward-looking investors who know that in the next one to three years, the market is going to provide some once-in-a-lifetime opportunities. And these investors will be ready to act when the opportunity presents itself. ❖