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Waiting Game

Investors Anticipate an Extraordinary Buying Opportunity, but Remain Patient for Now

by Larry Gray

Investors are raising capital and shaping strategies as market forces create diverse investment opportunities, ranging from whole loans to mezzanine loans, to CMBS, to equity investments in residential land and property types of all shapes and sizes. The anticipation of the coming opportunities is high, but transaction activity remains low as investors wait for property markets and pricing to adjust further.

It's been called "the investment opportunity of a lifetime" and real estate's "Super Bowl of the Century." For investors with cash, the investment environment of the near future certainly looks that way. Real estate prices declined dramatically during the past two years, and credit markets constricted considerably, leaving borrowers strapped for cash just as a glut of mortgages are about to reach maturity. In the wake of this market distress, investors believe an opportunity exists to purchase assets at historically low prices and take advantage of real estate's performance as the economy eventually recovers.

But despite the high expectations for the buy-side opportunities, transaction activity remains relatively low. According to Jones Lang LaSalle's *U.S. Mid-Year Capital Markets Bulletin*, transactions during the first half of 2009 declined as much as 90 percent from the market's peak in 2007. Transaction activity plunged to just \$16 billion

in the first half of 2009, compared to nearly \$80 billion during the first half of 2008, and \$231 billion during the first half 2007.

"The ongoing crisis in the markets will present lifetime opportunities, but not yet," says Douglas Tibbetts, managing principal and CEO of TRECAP Partners.

Investors are preaching patience as the U.S. property markets continue to adjust downward. The near-term consensus view is for continued weak employment and further declines in commercial property values during the next six to 12 months due to weakening tenant demand and shrinking rents. The combination of a financing drought and declining property fundamentals will fuel "maturity" and "performance" defaults on commercial mortgages. Right now there are a lot of fingers plugging the holes; however, pressure is building, and it's only a matter of time until the dam breaks.

"We are waiting for owner and borrower capitulation," says Tibbetts. "It's just a matter of time before banks and special servicers begin to act. It may take some sort of government intervention in an RTC mode to create a clearinghouse for all the bad debt. When that happens we'll be in a half-price sale environment."

But Tibbetts says he doesn't expect any of that to happen until well into 2010. His advice: "Keep

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Waiting Game

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your powder dry for now. It is going to get worse before it gets better.”

DEFINING THE OPPORTUNITY

The opportunity ahead could be characterized as a simple case of supply and demand: A massive imbalance exists between the supply and demand for capital, and due to this shortage of capital, investors will command a return premium relative to historical norms.

The driving force behind the anticipated buying frenzy is commercial real estate’s potential refinancing crisis. The scarcity of credit will make it extremely challenging for borrowers to secure refinancing, and in addition, a large number of mortgages that were originated during the market bubble years (2005–2007) will not qualify for refinancing under the new, stricter underwriting standards. An April 2009 report produced by Deutsche Bank calculated that maturing loans from three primary sources — the CMBS market, banks and life companies — would total more than \$1.4 trillion during the five-year period 2009–2013 (see “Annual Maturities of Commercial Mortgages,” below). The report concludes that with limited sources of debt capital, these commercial mortgages will face formidable refinancing problems. It states, “Without a doubt, the period

2010–2013 will be one of very significant stress in the commercial real estate market.”

Real Capital Analytics reports the amount of distressed assets — commercial properties in default, foreclosure or bankruptcy — is growing worldwide. Through the second quarter the level of distressed assets globally stood at \$233 billion, an increase of 112 percent since year-end 2008. In the United States, approximately \$132 billion of properties were in distress (see “Distress by Property Type,” page 12).

Add to that the appeal of lower real estate prices, and it’s easy to see why investors see potential deals ahead. Real estate assets have priced down by 35 percent to 50 percent from the peak levels of 2007–2008, with the scale and speed of decline varying depending on the market, property type, and asset quality and location, according to a report by CB Richard Ellis.

Randy Mundt, CIO of Principal Real Estate Investors, says expected peak-to-trough valuation corrections suggest that core properties can be acquired at prices that generate an expected unleveraged internal rate of return of 10 percent to 12 percent, while using reasonable assumptions regarding economic and job recovery.

“Uncertainty regarding the trajectory of job recovery and other key demand drivers such as consumer spending suggest that high-quality, well-leased properties with little near-term rollover may offer

the best relative value,” he adds.

Some market prognosticators are expecting a flood of properties to enter the market as financial institutions face mounting delinquencies and growing REO, but whether or not there will be heavily discounted fire sales is debatable.

“I don’t believe there will be fire sales,” says Chris Graham, a managing director at Starwood Capital Group and co-head of U.S. acquisitions, focused on the eastern region. “Most of the sales will be done in an organized process using brokers, and the FDIC and regulators will play a role. I do think regulators are encouraging some of the banks to sell; in recent months we’ve seen some banks reduce asking prices on assets that have been around for a while. We’ve also seen some banks forming ‘bad banks’ where they put a pool of challenging loans in a bucket with the plan to sell them over a three- or four-year period. A regional bank we spoke with recently, for example, has a bad bank with about \$1 billion in loans, and its plan is to sell those over a four-year period.”

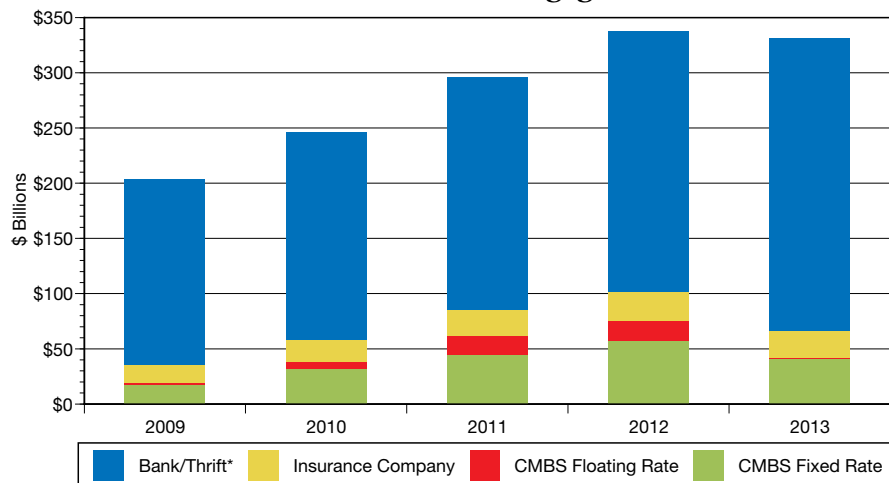
Lee Neibart, global CEO of AREA Property Partners, says it’s how the financial institutions eventually choose to handle those properties that they take back that will determine whether or not it is actually an investment opportunity of a lifetime.

“If they choose to hold on to these assets, invest capital and then wait for the recovery, then we believe they will be the beneficiaries of the rewards,” Neibart says. “If, however, for their own balance sheet issues, they choose to dispose of these assets at current market value, then we believe with the proper use of capital and property knowledge, this could be a spectacular buying opportunity.”

Many investors now are lining up for opportunities in distressed debt and whole loan mortgage origination, with the belief that private equity investment opportunities, for the most part, will emerge further along in the cycle.

Fred Lieblich, managing director and global CIO of the real estate business for BlackRock, for instance, sees current value

Annual Maturities of Commercial Mortgages



* maturity timing is estimated

Sources: Deutsche Bank, Intex, Trepp, Mortgage Bankers Association, Federal Reserve

“As the capital structure of each property is recast, there will need to be a significant amount of equity injected to make these assets viable again.”

– Fred Lieblich, managing director and global CIO, BlackRock

across the debt side of the capital structure. “We think there is significant value in whole loans and mezz. The opportunity on the equity side will play out as more distress enters the market and illiquidity continues to be a problem. Specifically, as the capital structure of each property is recast, there will need to be a significant amount of equity injected to make these assets viable again,” adds Lieblich.

Other investors have placed bets on the housing market, buying heavily discounted residential land in anticipation of an eventual market rebound.

HISTORICAL PERSPECTIVE

Those investors who are lined up with cash at the ready today have an example from history to look to in the real estate market crash that occurred with the Savings and Loan Crisis of the early 1990s. During that time, the real estate vulture funds that swooped in to capitalize on the RTC’s sell-off of assets from the failed savings and loans proved successful. Today’s investors expect the magnitude of the impending opportunity to be even greater, as the size and scope of today’s problem dwarfs the S&L crisis of the 1990s. The real estate meltdown of the 1990s was U.S. focused; the situation today is global.

“This time is worse,” states Tibbetts. “The distress is more broad-based, across the entire financial landscape, dragging commercial real estate with it. We’re more the innocent victims this time, compared to last time when we created our own problems, especially with overbuilding.”

The differences between the two situations don’t stop there. “The market downturn in the early 1990s was mostly driven by a massive oversupply going into a recession, which then led to significant repricing of real estate assets,” explains Lieblich “During that period the NCREIF index was down 35 percent on price. If you compare that to what we are seeing now, pricing has actually dropped much further.”

In the 1990s commercial banks saw the sale of REO as an opportunity to cleanse their balance sheets and focus on growing their core banking business. Today, financial institutions are focused on slowly working through these issues, rather than quickly packaging the problem assets in bulk and selling them right away. There’s no doubt some of these financial institutions are looking at the situation and thinking, “History tells me that a little bit of patience and a little bit of work could materially pay off.”

The distress at the property level today is nowhere near what it was in 1992, when office and retail vacancy rates were around 30 percent and life company mortgage delinquency rates were 7 percent. As of second quarter 2009, national office and retail vacancy rates registered 15.5 percent and 12.0 percent, respectively, according to CB Richard Ellis. At the same time, mortgage delinquencies are hovering around 0.2 percent, according to the American Council of Life Insurers (ACLI).

While property market fundamentals are weakening, distressed owners and borrowers, more so than distressed real estate, will fuel the forthcoming investment opportunity.

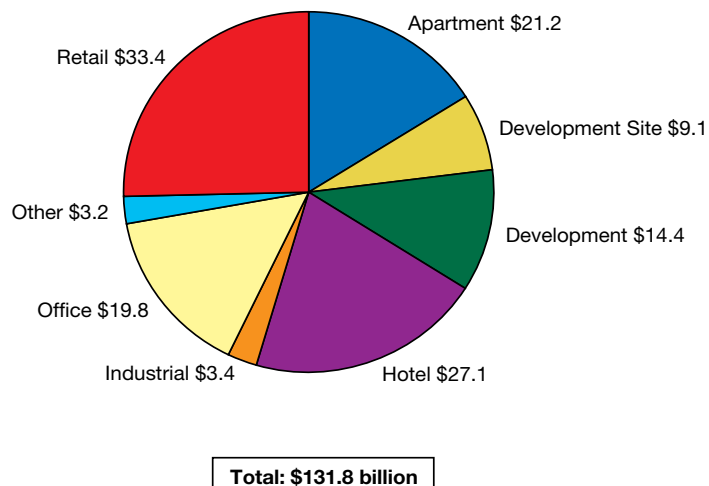
Another stark contrast between the early 1990s and today is in the realm of financing. In the early 1990s investors could buy in bulk from the RTC or financial institutions and readily obtain 50 percent to 60 percent financing on their cost. Today’s financing situation is extraordinarily more challenging. As has been stated many times, in the current market, cash is king.

But the two investment environments aren’t completely different either. As Thomas Barrack, founder, chairman and CEO of opportunistic investment firm Colony Capital, said in 2001: “When you find inefficiency, you find opportunity.”

GETTING INTO DEBT

When the CMBS market went dormant and conduit lenders shut down, it effectively left a huge void in the financing market for commercial real estate, but it also opened up an investment opportunity for those with cash to fill that void. In 2007 CMBS new issuance totaled \$230 billion, accounting for almost half of all new commercial mortgage originations; in 2008 new issuance registered a paltry \$12 billion. In addition to the demise of the CMBS market, commercial banks have pulled back on new lending to focus on resolving their existing portfolio problems. While many life

Distress by Property Type (\$ billions)



Source: Real Capital Analytics

companies are still in the market, the lion's share of their capital is dedicated to refinancing maturities in their own portfolios.

"The big opportunity now is in the whole loan market, where it's similar to the opportunity we had in 1993 and 1994," observes Kurt Wright, CEO and partner at Quadrant Real Estate Advisors. "Over the next five years there will be lots of loans maturing, and borrowers don't have a lot of options. Making loans on high-quality real estate with good borrowers is an excellent safe play. If you go back to the 1960s, all the ACLI data show the best loans are always made during a recession."

Numerous debt-oriented funds have raised capital or are seeking to raise capital with strategies focused on originating first mortgages and mezzanine loans, as well as acquiring B-notes, nonperforming loans and performing loans. In addition, a number of firms are tapping the public markets to launch mortgage REITs. Starwood Capital Group recently launched a mortgage REIT, Starwood Property Trust, which raised \$950 million in its IPO. The public vehicle will target performing loans, anything from first mortgages to mezzanine and B-notes, and will both buy and originate mortgages. Transwestern Investment Co. also announced the formation of a mortgage REIT, Transwestern Realty Finance, which is seeking to raise \$500 million in an IPO. The REIT will focus on the direct origination of commercial real estate debt.

"From what we've seen in the marketplace right now, there is plenty of capital out there, but there is less capital providing first mortgages and even less originating mezzanine loans," says Starwood's Graham. "That's where we think the REIT will fill a void in the market. The life companies tend to be between 50 percent and 60 percent loan to value; for new first mortgages, we will go up to 65 percent LTV and potentially a little higher for a risk/reward we really like. The REIT has the benefit of not having any legacy issues to deal with."

Graham believes first mortgages will generate returns of 8 percent to 9 percent on loans of up to 55 percent

to 65 percent LTV, while B-notes on first mortgages or mezzanine loans will generate IRRs in the mid-teens. He adds that loan-to-own deals should produce IRRs in excess of 20 percent, with the level of returns dependent on the risk/reward.

"For the loan-to-own-type deals, the opportunity really has not been that widespread so far," notes Graham. "In the last two to three months, however, we've seen a significant change in the market. There is much more product coming to the marketplace. There haven't been a lot of closings yet, but there are equity deals, debt deals. Volume should pick up in the last few months of the year, and that will help with price discovery. As more trades start happening, other sellers will follow; banks will see that and more loan-to-own-type opportunities will become available."

Wright is confident the CMBS market will return and advises that now is a good time for investors to position themselves for that eventuality.

"Fixed-income investors need a material element of their portfolio to be AAA bonds," explains Wright. "There are very few AAA corporations in the world anymore. So to meet demand, you need to manufacture AAA bonds. The way that has historically been done is with asset-backed securities such as CMBS. Long-term there will be demand for asset-backed bonds. The most likely source for that volume is the real estate market. The future market may look different, but the CMBS market will return," assures Wright.

"Between now and then, though, a great opportunity will be making whole loans in large volume," Wright advises. "In your low-case scenario, if that is all you ever do, you earn a 9 [percent return]. In the upside scenario, somewhere along the way the CMBS market re-emerges and you have the opportunity to sell your portfolio for a gain. Or you leverage it via government financing or through the re-emergence of the CMBS market, and then you can earn a very high return. In the short term, the name of the game is assemblage."

Buy! Buy! Buy!

Words from the Bullish

"The best buying opportunities that we have ever seen are going to happen in the next 18 to 24 months."

— **Jeffrey Schwartz**, former CEO of ProLogis, who is now involved in an Asia investment venture

"The next several years should provide returns well in excess of what we achieved following downturns in the '70s, '80s and '90s. We firmly believe this cycle is the real estate 'Super Bowl of the Century' if investment management firms are well capitalized and deploy that capital wisely."

— **Douglas Tibbetts**, managing principal and CEO, TRECAP Partners

"The next few years will offer a once in a generation opportunity for savvy investors to buy great assets in major markets like the U.K. and Germany, on sensible terms."

— **Marc Mogull**, managing partner, Benson Elliot Capital Management

"With stronger income growth projected after 2012 and many bargains likely to emerge, the next few years will produce some of the best opportunities for new investment the real estate market has ever seen."

— **Jacques Gordon**, global strategist, and **Bill Maher**, North American strategist, LaSalle Investment Management, note to clients

A blast from the past:

"We may not see another market like this for as long as we live. Five years will pass, and we will look back and realize that we either took advantage of an incredible opportunity, or that we let it slip away."

— **Michael Falker**, founding principal, Cambridge Realty Partners, assessing the commercial real estate markets, *The Institutional Real Estate Letter*, August 1991

“I don’t think there is any doubt that the forces coming together will clearly create an extraordinary opportunity. Will it be the opportunity of a lifetime? I don’t think we will know until we see it play out.”

*– Paul Kazilionis, founder and
CEO, Westbrook Partners*

PATIENCE IS A VIRTUE

While there is a shortage of capital, investors are running long on patience. Most buyers seem to realize that pricing is heading in their direction, and more deals and better deals are on the horizon.

“Few feel that pricing has adjusted enough to reflect the fundamentals going forward,” says Lieblich. “It probably will be another two or three quarters before the U.S. market enters the distressed phase. Until that happens, there will be a cloud over the transaction market and there will be continued downward pressure on pricing.”

Banks, like property owners, have been slow to recognize losses. CMBS holders and their special servicers are tangled in a web of tranches and intractable conflicts, and no one seems to be able to drop the hammer on borrowers who are clearly underwater.

“It’s suspended animation until these owners are forced inevitably to capitulate,” says Tibbetts. “Only then will the transaction markets resuscitate and opportunistic buying begins. Until then nobody will pull the trigger.”

For now, lenders are doing what real estate observers call “pretend and extend,” giving borrowers more time in the hope the economy will rebound. That can’t go on indefinitely, however. As default rates increase, lenders will be motivated to increase the rate of foreclosures.

Opportunistic investors are busily preparing and waiting for the day

of reckoning. Despite the slowdown in fund-raising activity during 2009, many global real estate investment managers have a ready stockpile of capital, considering that a sizable chunk of the \$270 billion of equity raised during 2007–2008 is still seeking a home.

For example, AREA Property Partners’ latest opportunity fund, AREA Investment Fund VI, had a first closing with \$500 million. Now it has an additional \$150 million of commitments. The fund has yet to make any investments, according to Neibart. “And our investors are happy with that,” he adds. “We, of course, update them all the time on how we view the market. But the truth is, if we would have invested in the past six months, we think it would have been the wrong decision. We have \$3 billion in dry powder across our funds worldwide. If we are patient and careful, our investors will be rewarded. Once markets reach stabilization, we will be able to more accurately predict where things are headed.”

DON’T FORGET THE DISCLAIMER

As the small-print disclaimer at the bottom of many investment offerings and documents notes: “Past performance does not guarantee future results.” Even though opportunistic buyers during the S&L crisis were handsomely rewarded, today’s investors still have good reason to be cautious.

“Unlike the quick economic recovery that followed the early 1990s, I think investors today have to consider very turbulent credit markets for the foreseeable future, and they cannot expect to be bailed out by sudden economic growth,” says Paul Kazilionis, founder and CEO of Westbrook Partners. “I just don’t see that on the horizon.”

Investors are wary of a prolonged economic recovery, especially in the United States. Unemployment, flat wages, tighter credit, fear of layoffs and an urge to save more in these uncertain times have caused many consumers to spend less. Shrinking home equity and stock portfolios have compounded the problem. As a result, U.S. consumers

are in no position to fuel an economic recovery.

Important questions still need to be answered. Where are jobs going to come from? What’s going to be the engine for hiring and economic growth? How long will it take to restore consumer confidence and spending? Will savings rates rise to a higher secular level, reducing growth in discretionary personal consumption? Until those questions are resolved, it’s wise to maintain a degree of economic pessimism. Market players stress that underwriting and pricing need to reflect the possibility of an extended economic malaise and a period of weak property fundamentals.

“Housing, employment and capital flows have to normalize before commercial real estate values recover,” adds Tibbetts. “This will not be immediate.”

Some fear that a return to growth could be delayed due to inflation and that rising interest rates resulting from the huge financial stimulus could hold down spending and hiring. Other investors fear a possible value trap, a situation in which they invest at current depressed prices only to see economic conditions deteriorate and prices decline further.

But to the extent that the economy recovers, investors who take advantage of the distress will be rewarded. Quality real estate assets historically have been a good bet in a rising price market, and in decades past, distressed buying opportunities have yielded pretty fat returns for savvy, opportunistic investors. Investors’ appetite for distressed deals is growing, and the number of parties gathering around the table continues to grow. But for now, most buyers are passing on the appetizers and ravenously waiting for the main course.

“I don’t think there is any doubt that the forces coming together will clearly create an extraordinary opportunity,” says Kazilionis. “Will it be the opportunity of a lifetime? I don’t think we will know until we see it play out.” ♦

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Institutional Real Estate, Inc.
