

February 25, 2009

Written by Randyl Drummer (rdrummer@costar.com)

TROUBLED ASSETS: CRE Investors May Soon Glimpse Opportunity Amid Hazy Market

Reports: Commercial Real Estate Pain Will Last for Years, But Nimble Players Could Find a Window That Will Open and Close Very Quickly This Year as Debt-Ridden Owners Unload Distressed Assets

Call it optimistically hopeful, but federal policymakers this week said the national recession could end this year, with the beginnings of recovery possibly taking hold in 2010. A pair of recent reports suggests that all is not lost for battered commercial real estate investors as well. In fact, the reports predict that a window of opportunity will probably open up within months for shrewd and well-capitalized investors as troubled assets begin to enter the disposition pipeline.

In particular, analysts expect institutional investors to be in a good position this year to take advantage of changing conditions in a market that has swung hard over to the downside, according to a report by Prudential Investment Management (PIM), the asset management arm of Prudential Financial, Inc., titled "Turbulent Markets: Challenges and Opportunities for the Institutional Investor."

"The dislocation in the financial markets has left institutional investors with a range of attractive investments across practically every asset class, and in every region of the world," Prudential Investment Management CEO Charles Lowrey said. "That creates opportunities in the long run, but also demands that [defined-benefit] plans absorb the lessons from the current crisis so they are well-positioned for a new economic reality."

Investors will need to be more than simply well positioned with ample cash, however -- they'll also need impeccable timing, and the requisite dash of good luck won't hurt, either. Once open, the window to grab assets at the best prices could slam shut very quickly, a new capital markets report by Jones Lang LaSalle states, noting, "once the yield ceiling is set, the crowd will invariably follow."

Despite the cautiously upbeat pronouncements by President Obama and Federal Reserve Chairman Ben S. Bernanke on the broader economy, optimism has been in particularly short supply of late in the battered commercial property markets. Values have tumbled 20-25% in many large markets, much more in some secondary and tertiary markets. Transaction activity has remained flat and net absorption and new development will likely continue to weaken for the next six to nine months.

Bernanke said on Wednesday the recession could end this year if the various government and market interventions are successful. But earlier this week, Atlanta Federal Reserve Bank President Dennis Lockhart didn't sound as optimistic as his boss, warning that \$400 billion in commercial mortgage refinancings leave many U.S. banks "pretty heavily exposed" to woes in commercial real estate, which he described as "a domestic factor that keeps me up at night."

Granted, trying to time investments in volatile markets and predict when real estate equity values will turn around can be a fool's errand. Buyers -- even those with the deepest pockets and strongest lenders -- are likely to stay cautious throughout the year. Sellers are just beginning to come to grips with the harsh re-pricing of property, JLL's report acknowledges. If credit markets don't thaw, commercial transaction volume could fall another 30-40% this year, the report stated.

CB Richard Ellis wrote down \$100 million in impaired real estate assets, primarily in its development and global investment management business, in 2008, hoping value declines that reached unprecedented

CONTINUED: TROUBLED ASSETS: CRE Investors May Soon Glimpse Opportunity Amid Hazy Market

levels in the fourth quarter have also reached a trough, Brett White, president/CEO, said earlier this month.

"Near-term prospects are tough in the development and investment management business," White acknowledged in reviewing the company's 2008 financial results. "But the good news is that with the devaluations we've seen across the assets classes, as you look into late 2009 and 2010, there ought to be opportunities in the marketplace that we may not get a chance to look at for many years.

"Our goal for that business is to have it positioned properly to return profit, and then be ready when opportunities arise and property markets return."

For news on development, corporate site selection, significant land transactions and commercial real estate trends, join the distribution list for CoStar's free weekly In The Pipeline column and newsletter. Read this week's edition.

As Always, Timing is Key

Transaction volume seems to be bottoming out now and may begin to pick up during the second quarter, fueled in part by owners forced to sell their assets to refinance or repay hundreds of billions in mortgage debt coming due, the JLL report stated.

The wild card is the precise timing of all these forced sales that are projected, and the effect they will have on pricing. Most troubled assets have not yet gone into default or foreclosure and back onto the market because lenders would rather refinance or extend maturing loans than take back property. Of lenders surveyed by Jones Lang LaSalle for its annual loan production survey earlier this month, more than 80% of respondents expected that at least 40% of their loan allocations will go toward refinancings. Another 13% expected refinancings to make up as much as 100% of their portfolios.

Slightly more than half of lenders surveyed expected overall loan production to increase this year compared with 2008. But of those who expected to increase lending, none were banks or life companies. All were private-equity lenders or government sponsored enterprises such as Fannie Mae and Freddie Mac.

"The lending community doesn't want to inherit assets through foreclosure, as most lenders we surveyed are willing to provide some form of forbearance, though the level varies case by case," said David Hendrickson, JLL managing director, real estate investment banking.

As leveraged properties run out of extensions and are forced to trade, market-clearing prices will finally be established, "and the broader market will at last have the data points it needs before participants can truly begin to emerge from the paralysis," the JLL capital markets report stated. "Certain high-quality assets will become available at pricing unlikely to be seen again for multiple economic cycles."

Despite the complex challenges, "2009 may prove in future years to be most remembered for presenting some of the most attractive investment opportunities in living memory for astute investors who are very focused on quality assets in the market and armed with large amounts of equity at their disposal," JLL said. "Pricing, and the opportunities for realizing long-term capital appreciation in real estate portfolios may not, in hindsight, appear as compelling again for a generation."

Pension funds, life companies and other institutional buyers that have been on the sidelines holding onto their cash are well-advised to be at the head of the line when the market turns, as those first in will enjoy the sweetest fruits of the highest long-term returns, according to JLL. Private-equity funds won't likely miss out, either. London-based Prequin Ltd. this week reported that more than one-third of the funds being raised globally for closed-ended private-equity real estate funds is earmarked for distressed assets and debt, up from just 7% in 2006.

Advantage: Institutional Investors

Market volatility is making long-term decisions difficult for institutional investors, who will have to re-

CONTINUED: TROUBLED ASSETS: CRE Investors May Soon Glimpse Opportunity Amid Hazy Market

examine their portfolios and risk management strategies and processes. Pension funds and life companies still face enormous challenges: portfolio values are down sharply, straining the ability of investors to fund obligations, and illiquidity is making it difficult to re-balance assets. However, since they are relatively debt free, institutions should be best positioned along with REITs to capitalize on the market turmoil and shouldn't need to liquidate large portions of their portfolios at fire-sale prices, PIM noted in its report.

However, investors need to take a fresh look at their strategies and procedures to absorb the lessons from the crisis and to position themselves to take advantage of upcoming opportunities. PIM recommends the following for investment managers:

Re-examine investment strategies. Under-funded plans have to choose between investing aggressively to close their funding gaps and trying to reduce risk through liability-driven investing, which can create the need for higher contributions to raise funding levels. Plans that are fully funded or almost fully funded have more flexibility to adopt debt-driven investing to minimize future volatility.

Build stronger risk management tools. The financial crisis exposed risk management vulnerabilities on a number of fronts, and risk tools failed to adequately take into consideration deleveraging and other macroeconomic factors. Shoring up credit risk evaluation has also become a requirement after the crisis exposed the limitations of the rating agencies, and illiquid fixed-income markets swept away the information that market prices provide. Institutional investors should expand traditional scenario analysis and deepen credit risk management capabilities to better deal with conditions such as those that led to the current crisis. Plans will also have to better monitor and manage liquidity risk within their portfolios.

Develop more cautious and thorough manager selection. Institutional investors must make sure both external and internal managers have the skill sets, expertise and depth to deal with the unexpected. To become more diverse, smaller institutional investors may need to consider greater use of fund managers or larger multi-strategy funds.

Finally, since lack of transparency was a major contributor to the financial crisis, institutional investors must make sure their managers can provide it.

"The days of 'trust me' fund-raising are surely at an end, and managers unwilling or unable to provide insight into their investment process and positions will be at a disadvantage," Lowrey said.

REITs In Good Position, Despite Market Shellacking

As the economy recovery takes shape, public REITs will be significant beneficiaries of capital flows as investors look to take advantage of distress, according to a global capital outlook by Prudential Real Estate Investors (PREI).

"Similar to the early 1990s experience in the U.S., we expect that the public markets globally will be the least expensive form of capital, which should give public companies a competitive advantage in capitalizing on the economic recovery," states the report.

In the U.S., public REIT stocks are priced at levels implying a cap rate of about 9% and a dividend yield of more than 10% -- a compelling discount to estimated net asset value (NAV), according to Citigroup. That said, while cap rates are edging upward from historical lows, there are still too few transactions to determine true market value, according to PREI.

As prices decline and the economy improves, conservatively leveraged REITs will be in an excellent position to capitalize on investment opportunities. "Our public sector investment strategy will be to focus on undervalued, large-cap real estate companies with strong balance sheets and a proven ability to return capital to shareholders through dividends," the PREI report states.

Plenty of anecdotal evidence points to an overall cap rate expansion of at least 200 basis points in the last couple of months, according to Jones Lang LaSalle. For some lower-quality assets, and in some markets with weaker fundamentals and shallower buyer pools, the cap rate hike has been considerably more, JLL said.

CONTINUED: TROUBLED ASSETS: CRE Investors May Soon Glimpse Opportunity Amid Hazy Market

Institutional real estate owners are feeling the pressure to correct their appraised book values and many have already begun the process of substantially marking down properties. Some open-ended funds will also come under severe pressure to write down and begin selling off assets. JLL cautions that funds which straggle in marking down properties could face a dilemma similar to distressed REITs when they are forced to re-value assets and sell their portfolios en masse.

The sell side will include a growing number of corporate users impacted by the credit crisis and weak earnings. Forced to deleverage and strengthen their balance sheets, many are selling assets or executing sale-leasebacks, presenting an opportunity for risk-averse investors to own well-leased or fully leased property backed by quality corporate credit at attractive yields, JLL noted.