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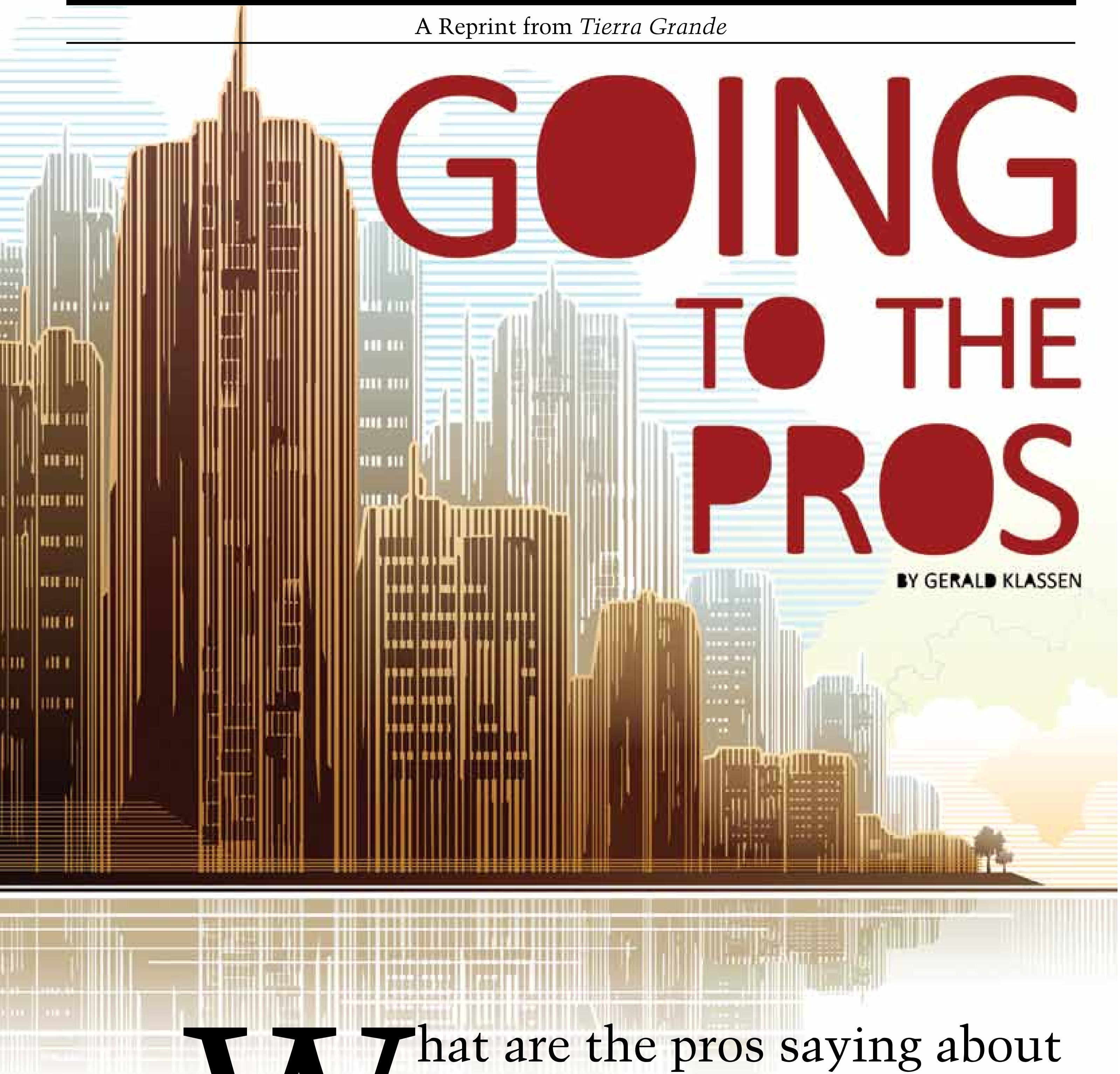
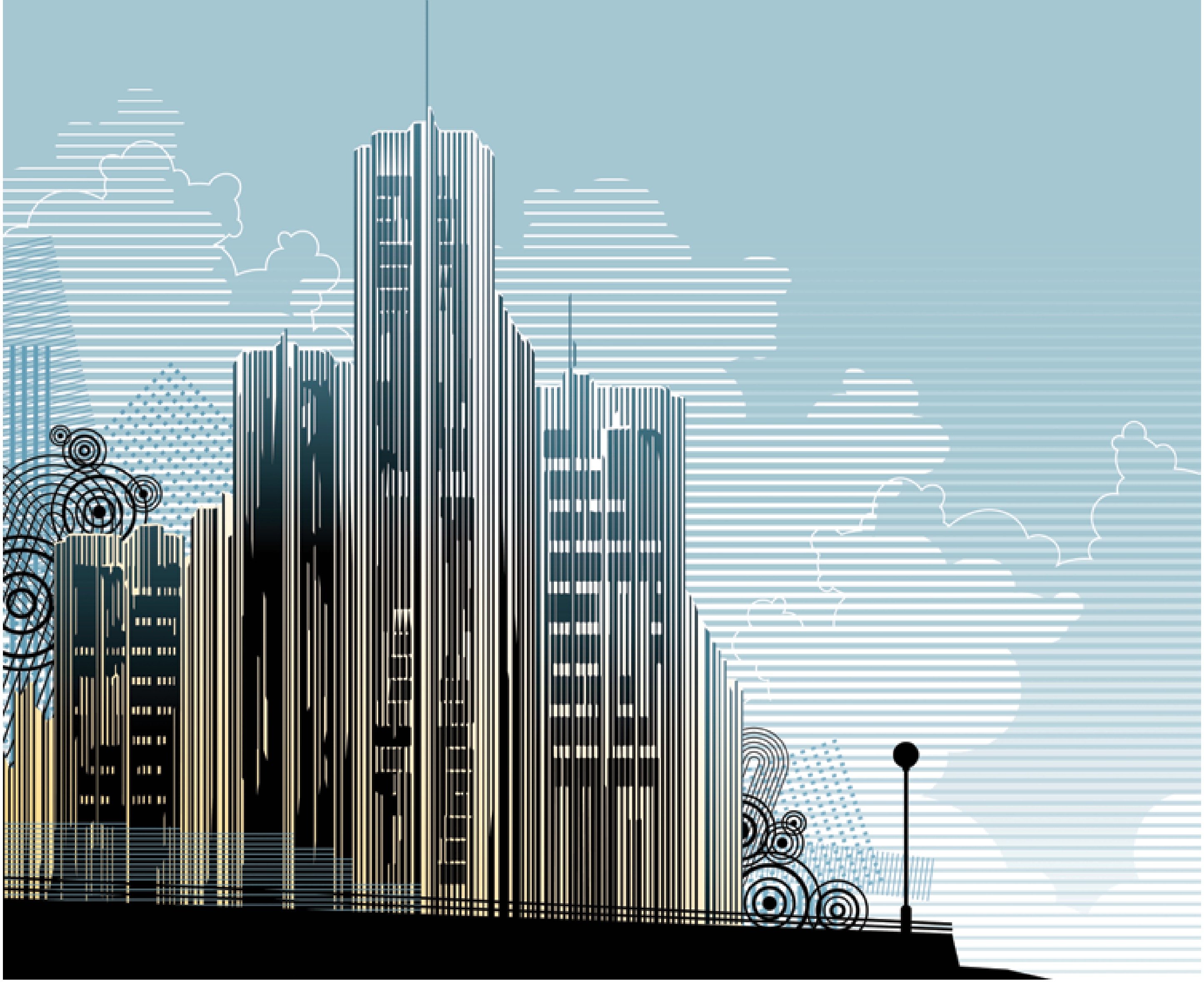


GOING TO THE PROS

BY GERALD KLASSEN

What are the pros saying about distressed commercial real estate? What can be expected for transaction volume and bank action in the coming year?



The Information Management Network hosted its third annual Bank & Special Asset Executive Forum in Fort Lauderdale, Fla., in February. Executives from around the country shared their perspectives on current challenges and what lies ahead.

This article is a partial transcript of panelists' comments.

National and Local Economic Overview: Will 2011 Be Different?

RICHARD HOLLOWELL
Managing Director
National Real Estate Practice Lead, BBK

Nothing is going to happen for a couple of years. A couple major banks did purging in the third and fourth quarters last year. The reality is that bank appraisals are still too high. When combined with a tough environment for raising bank capital, banks cannot afford to take losses across the board.

Banks will take their losses only when they really need to. Unless a bank marked an asset down to near trade value, we will see a sluggish approach to purging assets.

We may see the front end of mark-to-market this year only because a lot of banks are now experiencing second defaults. A grand majority of restructured loans from a couple years ago are still not able to perform. There was hope that a push for more cash could bolster the balance sheet. At this point the regulators and accountants are getting very edgy, so we will see the front end of mark-to-market start to occur.

BRETT FORMAN
President, Forman Capital

Transactions are going to increase in 2011 because of a snowball effect. If a new owner purchased a property at a low price at the end of 2010 and is able to cut rents in half when nearby properties have tenants coming up for renewal in 2011, the owners of nearby properties have two choices: lose the tenant to the property with lower rents or cut rents to a level that is unprofitable. Then you have another nonperforming property. This will cause more and more transactions at market clearing prices.

Residential real estate in Florida is at or near the bottom. In the commercial side we are just seeing the bottom dropping out. Forman Capital just purchased a retail property that is 60 percent occupied on a good hard corner and paid less than what the prior owner paid for the land.

BRAD HUNTER
Chief Economist and National Director of Consulting, Metrostudy

There are good projects in bad markets. Home prices come down to submarkets. In most markets prices are still experiencing downward pressure but within certain submarkets prices are increasing and builders are increasing their production.

Palm Beach County in Florida is a good example. GL Homes was able to raise prices through all last year at two major master-planned communities. They are doing the highest volume of any builder in the county. Many projects have been resurrected and made profitable. With all the building activity in Monterra in Broward County it is like the old days. The new owner comes in and remarkets the property properly and it can be successful.

Hollowell

There are lessons we can learn from the Resolution Trust Corporation (RTC) era. Between 1985 and 1992 there was virtually no credit for real estate. From the point of the first savings and loan failure in 1986, it took the RTC 6.5 years to perform a full slashing of values. Assets started to clear in 1992 and 1993. Properties that sold for 30 cents on the dollar in 1992 sold for 50 cents in 1993 and 75 cents in 1994. Money came out of the woodwork. Funds were put together to buy these assets and the market cleared. The RTC was put out of business at the end of 1995, one year before its sunset date.

What we are missing now is the widespread series of mark-to-market events. When you've got mortgage-backed securities servicers and banks trying to get 95 percent to 100 percent of appraised value on a new appraisal that is probably high, then you don't see mark-to-market happening the way it was a slash and burn in 1992.

Forman

The loss share agreements of the government are slowing the disposition process. It has enabled the government to keep the disposition from being a gusher.

The banks and private equity firms that get the loss sharing agreements have generally five years with interest free loans. One executive at a major bank commented that he has five years to sell. If he sells within two years he is out of a job. So he is looking toward year four or five to make it happen so he keeps his job. By not selling he can't make a mistake. By selling he can be questioned.

What we need is to get to market clearing prices a lot sooner. That means a lot more banks will experience a lot more pain. We know many more banks will go out of business but generally we are prepared for that.

There is private equity money, government money and big bank money. We just need to see the market clearing so we know where the bottom is and can begin building up from there.

Holloman

We need to narrow the bid-ask spread. Keeping it too wide is detrimental to cleaning up the mess. The FDIC is considering whether or not to continue the loss sharing approach to banks. They are considering instead cleansing the bad assets from banks and dumping them into a structured sale rather than leaving them in the acquiring institution that bleeds them into the market over a five-year period. The FDIC has had success with structured sales.

STEPHEN ROSENBURG
President & CEO, Dynamic Asset Management

Nothing is going to happen for two years. If you look at rentals, people come into the workforce and usually rent for about three years. We are going to have a rental burst, which we are in the middle of, until about 2012. In 2013, the single-family home business is where the upside is going to be.

Loan/Note Buyers Panel

SCOTT FARB
Chair, National Commercial Real Estate Practice, Reznick Group, PC

Good News

According to Real Capital Analytics, U.S. commercial property sales in 2010 reached $115 billion, fueled by investor demand for core assets in top tier markets. This was more than double 2009 volume. In December 2010 transaction activity topped $20 billion, making it the most active month since the market peak in 2007.

CRE prices on average were up 3 percent with apartment properties leading the way up at over 15 percent and retail properties leading the way down at 12 percent. Prices of investment grade and trophy properties surged almost 20 percent in 2010 with investors clamoring for these assets.

Prices across all sectors are still down on average close to 30 percent from two years ago. The pricing of distressed properties and loans continues to decline. On the public side, equity

REIT prices were up 28 percent in 2010 with apartment, hotel and retail sectors leading the way with returns of over 47 percent for apartment REITS, 43 percent for hotel REITS and 33 percent for retail REITs. REITs raised over $47 billion in equity and debt offerings last year.

Bad News

Industry wide, there is an equity gap of $400–$800 billion on the $1.4 trillion in commercial real estate loans scheduled to mature by 2014.

Commercial mortgage-backed securities (CMBS) delinquencies are over 9.3 percent, the highest in the history of the CMBS market.

An estimated $150 billion in CMBS loans are coming due by 2012.

Special servicers are currently dealing with $130–$140 billion in distressed loans. The level of distressed assets in default, foreclosure or bankruptcy is now estimated to be approaching $200 billion.

U.S. banks are holding $60 billion of distressed commercial real estate on their books with the FDIC holding an additional $30 billion available for sale.

JOSHUA HAMBY

Managing Director, Garnet Capital Advisors

In 2009 the expectations of sellers were not realistic. In the fourth quarter of 2010 my firm brought five deals to market for sale with a mixed bag of assets and we were able to sell 100 percent of three of the portfolios and 80 percent of the other two portfolios. What is really important for this market to increase volume is for deals to come to market that trade. And we are finally seeing that.

In the first quarter of 2010, banks were telling us that we should talk later in the year. This year we are working on deals to come to market late in the first quarter or second quarter. There are more active sellers. There should be more deal volume this year.

SOLON KANDEL

Principal, USI Opportunities and CEO/Manager of Ashwood Opportunities

We are starting to see banks make a commitment to rolling out a plan to start getting rid of notes and not simply sell through the real estate owned (REO) phase. There is more openness to a short or discounted sale situation. The environment for getting transactions done is looking a little more realistic.

ARNAUD KARSENTI

Managing Principal, 13th Floor Investments

In Florida, there has been price appreciation in fee simple single-family or townhouse land in the best locations when the land is ready for building. Some of the tertiary markets or tertiary locations in the best markets have had a very difficult time. If you can put yourself in the path of development, then you have a business plan.

RUDY ORMAN

Senior Vice President and Director of Business Development and Marketing, Residential Credit Solutions Inc.

Banks have a hard time selling residential mortgages at prices in the market. Non-performing residential mortgages are selling at 45 percent of unpaid principal balance. As an investor you can still lose money on that. There is a lot of risk with the collateral. At the end of the day everyone is unhappy. The bank is unhappy, the trader is unhappy. And they are tough deals to put together.

My firm has had more success going to the bank and offering to subservice the mortgage so the bank doesn't have to trade the asset. We will try to get the borrower current, refinanced or short-sold out of the portfolio. Subservicing is a good alternative for the banks because, from a regulatory perspective, it is not a trade that requires a mark-down that affects profit and loss. It is an outsourcing contract.

Farb

I have seen buyers purchase land for zero value and a percentage of the cost of improvements.

ARTHUR NEVID

Chief Investment Officer, Mountain Real Estate Capital

It is amazing how much is being paid for improved residential lots in some parts of the country. Folks are overpaying for these lots in some areas like Southern California. Nobody is paying anything for unimproved, unentitled land.

PETER COLLINS

Managing Principal, Forge Capital Partners

Watch what happens to cap rates this year. Four or five years ago everyone said cap rates will only go down on the best properties. Well more people came in and more money started chasing deals and we saw that money go further down the chain. It will happen again this year and next year.

Hamby

As an ex-buyer, I wouldn't buy any commercial property at today's prices. Risk is not fairly priced and it is a supply-demand imbalance caused by excess capital. We are going to see an inflection in the market where the volume of sellers exceeds buyers. We are going to see a drop in prices in the fourth quarter of this year or the middle of next year.

The capital on the sidelines won't be enough to handle the volume of properties coming to market. The market needs another RTC or forced selling. Instead of correcting the market over one or two years it will take four or five years to clear the market.

Collins

Interest rates and inflation are making underwriting difficult. It is one thing to get a seven-year fixed-rate loan at 5 percent on a property at 65 percent loan-to-value but what are interest rates going to be in five to six years when you go to sell the property? What effect will interest rates and inflation have on the underlying fundamentals of the property and the resulting cap rates? We can make assumptions on leasing, rent growth, interest rates and inflation but it is tough to know how that will correlate with cap rates because there is an irrationality about cap rates in the market.

It is tough for private capital to compete with the public capital of REITs.

Nevid

Current prices are not being driven by leverage but by the abundance of money out there chasing what few opportunities are available. A property must be an A property in an A location to get any kind of loan right now. We have a portfolio of B retail properties and there is no debt available for that. But people are buying it at prices that are crazy. Prices have come up. But there is some exuberance in the retail market again.

Kandel

The $350 billion dollar question today is "how long is the government going to keep the accounting rules the way they currently are set?" If they changed the rules back to the way they were before to recognize losses, 1,200–2,000 banks might fail immediately. It would throw us into another severe recession at best. There is at least that much in assets coming to market between now and 2014 and we need for the smoke to clear. It would be good if someone could tell us how this government action will play out so we know if it is good or bad. With all this going on we really don't know how quickly things are going to come to market. Whatever has come to market today, whether A or B class, has been sold for a low cap rate. There is a lot of money chasing a little bit of property.

Collins

It's our job as investors representing private capital to identify the ebbs and flows of that capital and where it is going and where you see opportunities within it. From an institutional perspective, the easiest thing to buy is a fully leased up shopping center or a multifamily A class asset.

Why are we buying land? It's not because we like land but it's an asset class that has been less sought after because banks won't lend to it and most institutional capital considers it a four-letter word. So as a result there is a big funding gap. When you go to negotiate a land deal with a bank you are among three or four other groups, not 30 or 40. So it's our job to constantly look forward to where values will rise and make a forward looking investment.

Deal flow has definitely picked up across all asset classes over the last year. Deal flow is not the problem. It is the buyer that is willing to pay an irrational price that's the problem. It causes you to go out to places where that buyer isn't or where there's less of those buyers. I'm just not ready to go buy vacant lots yet.

Where would I go for opportunities? I would look for a shopping center that had a vacancy level unacceptable to a public buyer because public REITs don't want to fix properties, they just want to get income. Redevelopment, rehab, retenanting, repositioning, the heavy lifting stuff in a shopping center environment where you are purchasing the shopping center for $12 million and it needs $4 million of renovation and tenant improvements.

Kandel

I think the most opportunity in the next year will be in the hairy stuff — redevelopment, repositioning, value-added assets — that eliminates a lot of institutional buyers and passive investors. It's guys with dirt under their fingernails who understand the market and can work assets. Beyond that, I think opportunity will come to those who are developing their relationships and are patient, persistent and not annoying. They are not asking for things of banks that the banks can't deliver. So if you go into the bank and say "I buy everything," that will be the last phone call for quite a while because banks don't want to hear that.

Karsenti

When we talk with home builders, the lack of jobs freezes the market. But there are pockets of opportunity. Take busted condos, highrises in Miami. Who could have predicted this massive influx of South American capital, most notably Brazilian and Venezuelan, that came in and gobbled up condos at prices that didn't make sense on anyone's spreadsheet or didn't have any residual value to them. The reason is the flight of capital, the flight to security.

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THE TAKEAWAY

Commercial transaction volume will be higher in 2011, but more distress is ahead. The decline in values will snowball. Good opportunities exist in local submarkets, but knowledge is key. Commercial market professionals should nurture relationships with banks so they can take advantage of opportunities as they arise.

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