



Commercial Real Estate: Where's The Payoff?

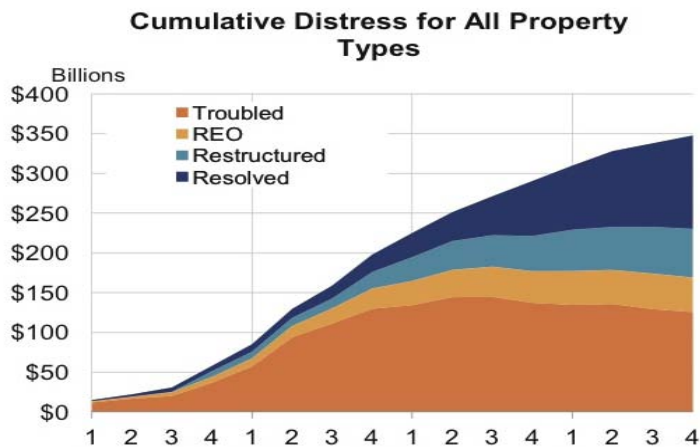
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Every economic contraction teaches hard lessons, and the Great Recession dealt punishing blows to the commercial real estate sector. Borrowers, lenders and investors bring different pain points and business agendas to the table, but they share a common focus: Will this deal deliver the expected payoff?

During the next couple of years, answering this question will require a level of scrutiny and understanding of CRE fundamentals that may be unprecedented. Stakeholders will reset their risk-return expectations as two complementary sets of activities evolve: (1) proper valuation analysis and (2) resolution of troubled loans.

Sharpen your pencils.

Investors are waiting expectantly, albeit warily, for deals in distressed property and loan portfolios to continue to surface in 2012. At the close of 2011, distressed commercial real estate in the United States (properties in default, foreclosure or taken back by lenders) totaled \$171.6 billion, based on data reported by Real Capital Analytics Inc. About \$30 billion in delinquent loans currently are pooled in commercial mortgage backed securities (CMBS), according to estimates by CoStar Group.



Source: Real Capital Analytics, Inc.

“In this market, you have to use a sharp pencil to find opportunities. Some deals will be home runs off the bat, but

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

some will be more challenging. When priced appropriately some assets will have no value,” says Jack Mullen, Founder of Summer Street Advisors. “It takes granular expertise to price a distressed loan appropriately for resolution.”

Despite the well-known adage that the three most important things in real estate are location, location, location, the general tendency is to apply the same return expectations across the board by asset class, without adequately accounting for local market conditions. Each market presents its own unique challenges that ideally would be reflected in different risk premiums, says Mullen. As examples, New York City is a more institutional market than St. Louis. Raleigh-Durham’s diversified economy would be relatively less risky than cities like Detroit or Cleveland, which have been battered by the recession, are suffering from high unemployment and are unlikely to replace lost manufacturing jobs for years to come.

CRE loan portfolio managers may need assistance from objective, third-party valuation consultants that utilize a robust valuation methodology. A thorough analysis would evaluate individual properties across a variety of parameters, including asset class, geographic location, cash flow, collateral, and financial measures, such as Loan-To-Value ratio. An ideal analytic framework applies a consistent set of rules across the board to clearly convey a deal’s risk-reward profile, for one property or for a portfolio.

Robin Goodchild, international director, LaSalle Investment Management (a division of global real estate firm Jones Lang LaSalle), also sees more intense focus on risk management. “It’s prudent to strive for a balanced collection of risk-return combinations during and after periods of great financial stress. As such, portfolio managers need to maintain a specific portfolio construction strategy, an investment discipline that compares required and expected returns, and a willingness to consider high impact scenarios that might trigger opportunities or threats,” advises Goodchild.

“It’s important to take analytics, street research and knowledge and wrap it with seasoned institutional experience to make an informed investment decision,” says Mullen.

Know when to hold, and when to fold.

There will be plenty of opportunity to sharpen the pencil as a record amount of real estate debt expires in the U.S over the next several years. Industry research firm Trepp, LLC, estimates \$350 billion of CRE maturities in 2011, \$360 billion

in 2012, and \$370 billion in 2013. Trepp forecasts bank loan maturities will peak in 2013 and CMBS’ share of maturities will increase in the period stretching from 2015 through 2017 as ten-year loans from 2005 to 2007 reach their maturity dates. Trepp estimates that banks are about 60% to 70% of the way through their CRE loss recognition, with another \$40 billion to \$80 billion in losses to be written off going forward.

While there is no industry consensus on loss realization for the CMBS sector, a significant percentage of loans maturing this year are at high risk of default, either because their collateral has seen a decline in cash flow, occupancies have faltered, or leases are maturing.

CoStar Group is expecting \$100 billion in CMBS loans to mature in 2012. Of that amount, \$70 billion is coming due for the first time, and another \$30 billion is already delinquent. According to sector reports, 2006 and 2007 vintage loans liquidated in 2011 suffered average loss of about 50%. Early industry predictions are that average losses of least 40% may continue for the next 12 to 24 months.

Citing a total average loan-to-value of 94.1%, Pooja Sharma, senior debt analyst for CoStar, encourages distressed-asset investors to keep their eye on the ball for increased opportunities as “we expect more of these loans to be resolved via liquidations or recapitalization modifications.”

Industry forecasts from Moody and Standard & Poors, predict at least half of 2007 vintage five-year-term loans maturing this year may fail to refinance. This scenario puts greater pressure on banks to resolve loans on assets that have no equity or collateral value. Banks, especially small and community, will have to find resources to:

- Properly value individual commercial properties
- Clearly identify their perfected (ownership) interest in the property
- Understand their jurisdictional foreclosure remedies
- Implement resolution plans
- Ensure compliance with regulatory mandates

“Banks typically are in the business of making new loans, not resolving them,” says Mullen. He points out that applying

local expertise to analytics takes on additional importance to determine how best to handle a distressed asset. “If the loan is non-performing, you may need to pay back taxes, there will be foreclosure expenses, and each jurisdiction has its own set of rules.”

“It’s important for banks to get outside assistance if they need it, so they can focus running the core business,” says Mullen.

Do banks have the internal research, analytic, legal, tax, compliance and client management capabilities needed to resolve problem CRE loans? Regulatory dynamics aside, the scope of this problem indicates that the banking sector lacks the infrastructure. Banks that allocate resources to meet the challenge faster – and more strategically – will likely gain a competitive edge.

Invest in fundamentals.

The sober reality is there is no immediate payoff from commercial real estate. Both equity and debt will be scarce over the next few years, so financing opportunities will be limited. As witnessed in 2011, well-leased properties in the strongest locations within the largest markets will continue to attract a pricing premium and find debt financing more readily available. For most other scenarios, liquidity will be hard to find.

2012 may be shaping up to be a pivotal year to position the sector for a more sure-footed recovery. Stakeholders cannot afford to be distracted by factors not directly related to CRE fundamentals, such as the depressed CMBS market, Euro-zone turmoil and additional regulatory uncertainty brought on by a U.S. presidential election year.

“Our advice is to keep focused on fundamentals,” says Mullen. “Proper valuation and due diligence are essential to a successful investment strategy every day of the year.”

Summer Street Advisors LLC (SSA) is a commercial real estate and financial services advisory firm. SSA offers a rigorous, data driven approach in providing commercial real estate and loan investment valuation and analysis, transaction due diligence, bank and REIT advisory, asset/portfolio management and loan underwriting.

For more information, contact

Jack Mullen, Founder and Managing Director

203.293.4844

www.summerstreetre.com