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Capital Market Recovery Will Take Time, but Could Start in 2010

Lenders Should (Finally) Begin Writing Off Their Distressed Assets, Allowing for Deployment of Sidelined Capital

The start of 2010 comes with fresh hopes in the realty capital markets, despite the continued impact of persistent recessionary burdens such as weak demand, falling values and constricted lending, as indicated by a string of commercial real estate industry outlooks.

After a turbulent 18-24 months since the market peaked, 2009 marked a year where transaction volume nearly came to a standstill. There is hope, though, that the economic uncertainty that has sidelined investors will recede resulting in more acquisition opportunities in the coming year as banks and financial institutions get around to cleaning up their balance sheets and move more aggressively to dispose of commercial real estate loans and financially distressed real estate assets, according to NAI Global's annual outlook.

Grubb & Ellis in its annual outlook is predicting an increase in sales volume of 20% to 30% over 2009 levels. However, prices, already down 40% from their peak in October 2007, may decline another 10% to 20% in order to meet buyers' expectations.

Property and Portfolio Research (PPR), is expecting an even bigger increase in transaction activity in 2010, fueled by increased distress on banks from loan delinquencies and "droves" of capital, led initially by foreign investors, expected to target major U.S. metro areas. In its recent "2010 Predictions" report, the CoStar subsidiary noted that, in the past year, banks were given and successfully used latitude in valuations and modifications. Along with the TARP injection, this latitude helped preclude a flood of distress and transactions.

PPR expects that trend to partially reverse in 2010 due to an expected increase in traditional payment distress and continued bank closures.

"Unlike loans with LTV issues, extensions are not the solution for those that cannot cover their payments, and many will be foreclosed upon and sold," according to the PPR report. "Delinquencies will continue to trend higher in 2010 as NOIs head lower."

Overall, the fact that banks likely will begin writing off their losses on distressed assets in 2010 means that the capital accumulating on the sidelines will start being deployed, and highly leveraged buildings, many without the capital necessary to attract tenants, will transfer to new ownership, removing what was a major impediment to recovery in the investment market, according Grubb & Ellis.

The hopes have been fueled by the federal government's financial industry stimulus money to prop up banks, financial support for the acquisition of some legacy assets and from the fed's continued support of low interest rates. In essence, the fed's action have created a "dual-personality" investment play, according to the Real Estate Capital Institute (RECI), a Chicago-based volunteer-based research organization that tracks realty rates data for debt and equity yields. Investors are seeking relief on legacy debt assets; while also trolling for fresh new debt and equity assets based on more attractively reset prices.

"Due to government intervention, the concept of distressed selling and buying did not materialize

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anywhere in North America," said Mark E. Rose, chairman and CEO of Avison Young in Chicago. "The U.S. government put money into the major banks, which in turn extended every loan they could to avoid realizing losses. The Securities and Exchange Commission watched from the sidelines and allowed the impacted lenders to postpone the inevitable."

"2010 is shaping up to be more of the same, but with a slightly positive bias," Rose said. "Fundamentals have firmed, decision makers are getting their sea legs back and the second half of 2010 should produce favorable comparisons to 2009. This, in turn, will drive the confidence we have been sorely missing and allow for activity to return to more normal levels."

The hopes may be realized but only with some sacrifice and a rethinking of investment criteria.

"Before recovery can occur in 2010, private markets must solve their own problems, even if that means capitulation; the bid and ask spreads need to narrow; and we must see job growth in North America," Rose added.

John Oharenko, RECI's advisory board member, said he believes this year we'll be bouncing along the market bottom as values continue to slide, but at less dramatic levels than last year.

"Some of the greatest investment opportunities lie ahead, especially for those buyers willing to sacrifice current return and rely upon overall market momentum to improve during the next three to five years," Oharenko said.

Until the hopes for the new year begin to become reality, however, RECI suggests that investors will continue to be frustrated in that more funds exist than there are placement opportunities in which to sink their money. The main reason is that buyers still expect lower prices but sellers don't want to realize heavy losses unless it is forced upon them.

According to analysis by CoStar Group there seems to be a steady stream of private and public money flowing into investment funds. During the past year, public funds (mainly REITs) raised more than \$25 billion of equity for income properties funds. And, more than 650 new funds and companies raised more than \$65 billion last year for real estate acquisitions. Most of the money raised (almost half) was being targeted for debt investments; about 25% was being earmarked for traditional commercial real estate properties; and the remainder for other types of real estate, including residential development and construction funding.

"Senior debt purchases are preferred by many investors who prefer to avoid untangling equity positions often plagued by multiple capital tiers including preferred and mezzanine funds," Oharenko told CoStar Group. "Multifamily continues to be the 'darling' of the income-property capital markets as the agencies [such as Fannie Mae and Freddie Mac] provide ample liquidity into this sector. Otherwise, commercial real estate property fundings are mostly focused on refinancing and workouts."

"The short leases of multifamily would be a pretty good hedge against inflation, particularly if you had long-term fixed rate debt in place through Fannie and Freddie," said Dr. Peter Linneman, NAI Global chief economist and principal at Linneman Associates. "Multifamily held up better in the recession until the capital markets fell apart, and as they fell apart, multifamily production fell to the lowest level in the last 60 years. That will pick up, though more slowly [than single-family] because it's more capital market dependent."

"The recession has been over for six months and job growth is just months away, but the fact remains it will be impossible to predict what will happen next," Linneman said. "With significant tax, health care and regulatory proposals still in the offing, there is little clarity as to the ultimate outcomes or costs. We're concerned with commercial mortgage delinquency rates as they have been on the rise and could keep the commercial real estate industry in neutral for several more months."

Aaron Gruen, principal of Gruen Gruen & Associates, a Chicago-based economics, strategic marketing and

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land use/public policy analysis firm, told CoStar Group that: "Real estate market demand for many markets and uses can be expected to be weak over the next few years. Foreclosures are rapidly rising. Transactions/development was limited in 2009 but should increase in 2010. Core assets have already been repriced and some liquidity from balance sheet lenders is returning, but underwriting standards will be much higher and therefore highly leveraged transactions will be constrained."

"Historically, real estate was viewed as an income-producing asset that provides an inflation hedge and is not correlated strongly with equity securities," Gruen said. "It may be the pension and other groups investing in real estate funds will find this historic role appealing and focus on backing groups using relatively low level of leverage and buying well located core assets perceived to have less risk in the short term and better long-term potential to produce long-term cash flows. These kinds of properties are priced lower than has been the case for at least five years. But those that do not need to sell will hold on to them."

"Perhaps, given the stress and adjustments required, it will simply take some more time for sellers to become motivated and buyers to raise and place capital," Gruen continued. "After all, [the] Great Recession has permanently altered consumer, investment, and governmental behavior. Both public and private sector interests which influence land use and economic development need to reset their models and practices to work out projects and plans affected by the Great Recession and to respond to the opportunities the economic recovery will present. But this will take time and not be easy."

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