June 2010

Transaction Advisory Services

Signs of a stirring real estate market

The real estate market is starting to stir. Though transaction activity is still minimal, sales volumes have risen modestly as capital raising expands. Meanwhile, delinquency rates for commercial, bank, thrift and commercial mortgage-backed security (CMBS) loans are continuing to build.

The trends point to increased transaction volumes and varied activity in 2010, including a rise in loan sale transactions. Valuations have generally declined 30% to 40% from their 2007 highs, and this has enabled the uptick in market movement. Although sales volumes remain low, a sense of cautious optimism is palpable in the actions companies are undertaking to ready themselves.

Credit, of course, is still constrained but is beginning to flow to high quality assets with strong backing, underwriting, equity investment by the borrower and a loan-to-value ratio in the 70% range. Pricing disconnects persist, but the gap is smaller.

During the first quarter of 2010, real estate companies raised approximately $12.2 billion of capital, comprised of $4.5 billion of common stock offerings (including three IPOs) and $7.7 billion in debt offerings. Commercial loan sales, both in the performing and non-performing loan areas (interest-earning current loans and loans in default), are also up, as evidenced by the FDIC's recent auction of $610.5 million in overdue real estate loans from 19 banks, including Indy Mac, Silverton and New Frontier.

With valuations still in flux, thorough due diligence is of paramount importance. Careful capital management is key to ensuring that prospective buyers and sellers have sufficient resources to move when opportunity strikes.

Economic realities

Amid falling rents and rising vacancy rates, some holders of commercial real estate are starting to accept discounted prices to cut their losses and preserve precious capital. This is unleashing new supply following recent stagnation after the market collapsed in September 2008. Such action is being seen especially in the commercial loan market as it moves to extract value from both performing and non-performing loans.

One large foreign financial institution, for example, had lent large sums to the North American market over the boom 2005-2007 years. This market was outside of this institution's core competency and, therefore, it recently decided to restructure and exit this market in an orderly fashion. That was accomplished through a combination of loan restructuring/modifications, loan sales and foreclosures on its non-core assets representing several billion dollars, of which 80% was distressed. The institution successfully unwound one of its loan portfolios worth several hundred million dollars in an orderly, non-fire-sale disposal, which allowed the institution to reduce its exposure and maximize its recovery. Certain other European financial institutions are similarly re-trenching their non-core loan portfolios which will result in a volume of disposition activity.

Government agencies, financial institutions and other real estate owners/operators are starting to build the infrastructure required to own real estate or loan portfolios that were reluctantly acquired during the market collapse. To manage the cumbersome process of valuing and selling those assets, these organizations are developing the people, processes and other resources to operate the underlying real estate. This new infrastructure must be able to analyze and decide whether to extend or foreclose on maturing and distressed debt. Likewise, institutions need to

choose between holding and selling an asset once ownership is attained through foreclosure, bankruptcy or deed in lieu of foreclosure.

One government agency acquired a multi-billion dollar portfolio of real estate debt in order to stabilize financial markets and ease market dysfunction. To manage this portfolio of debt, the agency developed a business plan and operating platform to enable risk management and maximize cash recovery. The operating platform design includes the development of third-party relationships with market participants such as special servicers, asset managers, property managers, appraisers and brokers. These parties work with the internal organization to manage the portfolio and maximize the recovery value of the portfolio.

Capital raising and securitization activity

IPOs and other capital raising, in tandem with increasing activity in the previously frozen securitization market, is seeding demand among prospective buyers as values stabilize. Underpinning buyers' interest, property prices have generally stopped falling, following the 40% or so decline in the past two years.

Coalescing supply and demand is boosting valuations and bringing would-be buyers and sellers to the bargaining table. Not surprisingly, high-quality, low-risk assets are most in demand as those with sufficient resources pursue a buy-and-hold strategy ahead of an expected 2011/2012 recovery. Current owners of real estate portfolios that don't have the wherewithal to maintain ownership as a result of declining cash flow are now starting to sell to buyers prepared to pay asking prices.

With approximately $8.6 billion of debt and equity capital raised by REITs during 2009 and continued capital raising during 2010, REITs are emerging as key buyers of property in all sectors of real estate. Private equity and sovereign wealth funds (SWFs), which have shifted from passive partners to active prospectors in the US, also are joining the buying fray as opportunities present themselves.

A number of major banks have returned to the CMBS conduit lending business, while others have made the decision to exit the business altogether. This trend is resulting in a slow but steady re-emergence of the commercial real estate securitization market. One major bank restarted its CMBS lending business in the fourth quarter of 2009 and continues to be very active. This year, it originated a portfolio of real estate loans worth several hundred million dollars that will be securitized. The underlying collateral reflected stabilized, low leverage (60% to 70% loan to value) properties with strong sponsorship. Other banks have started to follow this trend as they jumpstart their conduit lending business.

With a continued overhang of uncertainty, buy-side activity for REITs, private equity and foreign investors is up and should increase over time in all sectors. Buyers are spending far more time on valuation today than in prior years. As shoppers vet possible purchases, a key focus is net operating income (NOI), which is very hard to project in the current environment.

There is a very clear emphasis on returning to a thorough due diligence and underwriting process to evaluate opportunities arising in this market. Organizations raising cash for future acquisitions or lending activity are fortifying their underwriting and diligence capabilities and requirements. This includes functions such as cash flow modeling, lease abstracting, third-party report review (engineering, environmental and appraisals) and authoring credit committee reports. Many organizations disposed of these capabilities during the market collapse and are now rebuilding in-house or are outsourcing.

Capital agenda

With buyers and sellers coming together amid tight credit markets, how can companies best position themselves?

Companies in the enviable position of acquiring assets because they have ample cash are focusing on due diligence. They are upgrading strategic decision tools and capabilities for a thorough understanding of a complex and rapidly changing market so that they can extract maximum value during and after purchase.

On the other extreme, banks, businesses and companies facing a cash crunch are offloading large chunks of their portfolio to raise capital, which is boosting supply. They are also developing short-term cash and working capital plans for early warning and intervention and for capital restructuring.

Finally, those that are neither cash-rich nor cash-poor are optimizing capital through better planning, budgeting and forecasting tools to improve control and flexibility.

At long last, the market appears on the cusp of a meaningful uptick in real estate transactions. Commercial real estate loans from larger financial institutions will likely be today's opportunity amid recent guidance from the Office of the Comptroller of the Currency (OCC) on loan workouts. Tomorrow's may lie with smaller community and regional bank loans, as the regulators shift their focus to these banks where many distressed development loans are continuing to deteriorate. As this activity takes hold, buyers and sellers with the best information, processes, valuation models and capital agendas will benefit most.

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SCORE No. CE0657
1005-1161036

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