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(Not so) random thoughts on the commercial real estate investment market for 2010

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Capital flows to where risk adjusted returns are perceived to be the highest. This is a fundamental tenet of Finance 101. Capital hasn't slowed to commercial real estate since 2006, though to many of us it feels longer. This is often reported as a lack of capital availability. It's particularly visible to most of us when the business press reports on the banking sector. Unfortunately, this oversimplification tends to mask a discomfort with pricing levels and/or an inability to understand in price risk. Equity investors wrestle with the same issues.

If I believe half of what I've read, the economy is recovering, but the outlook for jobs (widely perceived as critical to commercial real estate recovery) is unclear at best and more frequently dismal.

Against that backdrop, many real estate assets are plagued by capital structures that don't match current market conditions and holders of those positions are perceived as unwilling and/or unable to recognize the "new reality". This creates an environment with natural tension at all the normal transaction points: buyers and sellers; lenders and borrowers; and tenants and landlords.

Almost every publication has contained a recent headline identifying opportunities and distressed assets. How real is this opportunity? First, evidence suggests that this is not 1991. Government pressure is not forcing restructuring matters and ownership changes. It's really going the other way. Banks are criticized for "pretending and extending" but we don't see that at all in our business. We see balance sheet lenders who value relationships and are bending over backwards for the right combination of good customers and fundamentally good assets. CMBS special servicers are a different story. The market lacks clarity regarding what they can and cannot do. This is a good time to wonder if the perceived savings achieved and other advantages from selecting the securitize loan versus the balance sheet loan are worth it in all circumstances. What an interesting test for the system. This suggests that yes; there is distress in the system. However, distress is not spread equally. Assets and capital structure participants with little to no cash availability are likely to represent the first wave of investment opportunities. Investors are thinking hard about risk, which these assets tend to have in abundance and pricing will likely be adjusted accordingly.

Following this difficulty, we see both debt and equity capital investors developing investment parameters that will enable them to resume their role as active market participants.

In this environment, what does it take to attract investment capital?

In our view, institutional investors (and probably others) will return to the fundamentals. The next generation of investment transactions will likely emphasize income rather than capital appreciation, creating what we call "the season of asset management". Operating skills and experience are expected to rise to the forefront as money will be made (or not lost) with the fundamental "blocking and tackling" required to manage day-to-day building operations, maintain tenant satisfaction, and

lease space.

So if you want help fixing a currently broken capital structure, taking advantage of someone else's misfortune (fixing a broken capital structures that isn't yours) be prepared to offer both an appropriate risk adjusted return on the capital you seek (remember that appropriateness is determined by the investor) and a clear detailed business plan with both strategic asset objectives and detailed implementation planning elements.

Attracting capital at this stage of the cycle is real work, rewarding and profitable work for those who do it well.

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