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2008 commercial real estate investment market: Challenges, changes and opportunities

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During the second half of 2006 and first half of 2007, both the pace and size of real estate deals rapidly increased. Many transactions looked like corporate mergers and acquisitions compared to traditional single real estate asset transactions. Large portfolio deals quickly became the norm with the Blackstone Group's \$36 billion acquisition of Equity Office Properties, the nation's largest commercial landlord, reported as the largest leveraged buyout in history. In addition to portfolio deals, large single-building acquisitions and sales followed suit, with expedited due diligence periods for the buyer's investigation becoming as short as five days.

However, by early fall 2007, the so-called "Credit Crunch" was upon us. Buyers reduced their offers based on increasing loan costs or their inability to secure favorable loans. Sellers became unwilling or unable to sell at reduced price offers and deals were terminated or renegotiated.

Many larger transactions had previously drawn much of their permanent financing from securitized loans, which rely on Commercial Mortgage Backed Securities (CMBS). With residential foreclosures affecting the banking and mortgage industry, the formerly large pool of Wall Street investors in the CMBS market quickly dried up, and the previously wide availability of securitized loans at competitive rates disappeared.

Outlook for 2008

In 2008, the large portfolio deals, at least in the short term, will be less frequent and require extremely thorough vetting. As stricter credit standards have been imposed and equity requirements of lenders have increased, our work as attorneys for borrowers has required different strategies. As attorneys representing lenders, we are placing more scrutiny on the due diligence of borrowers, their creditworthiness, and the details of the profitability and cash flow of the property being financed.

Normally the cooling of buyer demand would mean a shift of leverage away from sellers. However, at the large institutional asset level, we have not yet seen this to fully be the case. At least in the short term, we have seen a number of deep-pocketed owners - large REITs, insurance and pension funds, and private equity firms - decide to ride out the current credit-crunch by simply holding large institutional assets they formerly would have sold.

Of course, there are always some owners, who need to sell. Many debt-heavy owners with short duration interest-only loans soon coming due may find it difficult to refinance without significant

equity infusion and more demanding terms, and may see those rates reset at much higher levels. Unable to find suitable replacement loans, they may be forced to either sell (possibly at much reduced prices) or seek bailouts through taking on new partners or using mezzanine loans. In addition, the potential for increases in tenant defaults and the need to restructure leases or find replacement tenants may challenge many owners.

Shifting Opportunities

While some well-funded investors concentrate on true buying opportunities, many are shifting their focus to buying or taking positions in existing loans on commercial properties. Many so-called "opportunity funds" may take advantage of banks' needs to sell some of their current loan portfolios to cover losses in other areas. Alternatively, they may purchase property loans in anticipation of borrower defaults and the potential of the lender to then recover the properties. Other funds may provide mezzanine loans to assist owners who are feeling the adverse effects of the current market.

The duration of the current credit crunch remains to be seen. Many feel that the fundamentals of the commercial real estate market are still very good, and not much different than the fundamentals that created such a hot market less than a year ago. A well located development site having the right credit tenant sponsorship will still allow viable opportunities in 2008. There also seems to be considerable pressure from investors in the still very well-funded private equity firms to invest that money, and the money does not seem to be moving away from commercial real estate to other asset classes. Overall, with credit more scarce and lending requirements greater, the current environment certainly favors the larger, tested and experienced, well capitalized and not too debt-heavy, investors and owners.

As for law firms, the market's effect on the practice of commercial real estate law has been somewhat dramatic of late. However, seasoned commercial real estate attorneys are not newcomers to the cyclical nature of real estate. In 2008, as always, the most successful law firms will continue to adjust rapidly to accommodate their clients' varying needs.

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