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The Line Reports from Andrews Kurth's Mid-Year Real Estate Roundtable - Part II: Examining Investor Expectations and the Increased Role of Government

Posted on **June 26, 2010** by Peter K. McKee, Jr.

Continuing our series of posts from Andrews Kurth's 2nd Annual Mid-Year Real Estate Roundtable on June 22...

Bert Crouch of Invesco picked up the discussion, explaining why institutional investors had returned to commercial real estate. "Some of this is just the 'denominator effect' (devalued real estate represents a smaller percentage of their overall investment portfolio). Existing portfolios have been buoyed by the bounce in equity and bond markets, and troubled commercial real estate assets have become less of an issue on a relative basis. Institutional investors have also been hoarding cash. Anxious to avoid undue risk, many were on the sidelines while equities were rallying. Now they're trying to put out capital to catch up, sensing broader optimism and GDP growth, and they've increased their CRE allocations. 2009 was the year when the focus was on risk and finding high risk/high return assets. 2010 has seen investors in the frenzied pursuit of core assets—looking for large executions involving institutional quality assets. For open-ended funds, the pattern of investors queuing up to be taken out has seemingly reversed itself overnight. Internationally, Asia is seen as risky, while the U.S. is seen as a safe haven. With low interest rates and Asian currencies up, investors have found it attractive to repatriate their investments to U.S. funds with core asset strategies.

HFF's Trey Morsbach followed up with two additional observations: "First, as it relates to international capital, the Association of Foreign Investors in Real Estate (AFIRE) has always viewed the U.S. as standing above other foreign markets owing largely to the transparency of information and confidence in this country's public markets. Yields in other countries may be greater, but we've been safe. In last year's AFIRE index, the U.S. actually upticked compared to others. There is an unbelievable amount of capital available for core assets. Those of us here should appreciate that Dallas is not on the same footing as other gateway cities. There are very few CRE properties here that could be characterized as core assets from international capital's perspective.

"Second, to expand on Bert's point about relative value investing, we saw before that money flew out of real estate because everything else was cheap. Now real estate, both debt and equity, is a great relative value. For asset allocators like hedge funds and life companies, the stock market is iffy, the bond market is on the floor, and commodities are overpriced. Despite tight yields, CRE is a great relative value."

Added Bert, "It's even a great relative value within the sector. There was huge equity issuance in the REIT space last year. This year, REITs are raising less equity because debt is so cheap. REIT senior unsecured debt is priced at treasuries plus 200-300bp over—that's about 6% for 10 year money. For people who want to invest in CRE, with no REIT equity raises and no new issue CMBS, they're looking at the private lending space."

In examining what helped stabilize the capital markets, Andrews Kurth's Pat Sargent acknowledged the catalytic role of government programs like TARP and TALF. "In early 2009, the then-CMSA (now CRE Finance Council) lobbied hard for Treasury to expand TALF, which was initially aimed at consumer-oriented asset-backed securitization, to include both legacy and new issue CMBS as well. Secretary Geithner recognized that, despite having been villainized, securitization was critical to economic recovery because it provided some 40% of consumer and commercial finance. With the announcement that TALF would be expanded to commercial mortgage-backed securities in May of 2009, CMBS traded 500-700bp tighter overnight. So TALF did the job of bringing spreads in, even though TALF lending was hardly ever used for new issuance CMBS. Without that, higher CMBS yields would have meant that interest rates to borrowers would have remained at astronomical levels.

"With that, it would have been best if the government just walked away, but the ensuing white paper on regulatory reform indicated that CRE was going to feel the reach of government in unprecedented ways. The House and Senate bills on financial regulatory reform are a prime example of this."

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Trey followed: "Investors used TARP as a safety blanket. Nobody wanted to do business with the government. Borrowers under these government programs were tied up tight."

Does the return of liquidity affect the special servicer's approach?

C-III's Lindsey Wright responded: "We know there's liquidity out there and capital in play. 90% of our maturing portfolio has been paid off, and it's not just in the multifamily sector where the GSEs never stopped lending. Statistically, 99% of our multifamily loans have refinanced, and our maturing retail loans are sub-70%. Still, we have some \$4.5 billion of loans maturing in the next 12 months, and another \$7 billion maturing in the successive 12 month period, so we'll see how that plays out. There's certainly no shortage of interest in our REO or non-performing loans. The big boys are back. We had a \$300 million pool comprised of 60 assets that was conducive to smaller investors, but the bigger investors are all over our nonperforming loan and REO portfolios, looking for opportunities."

Bert described the focus of Invesco's opportunity fund: "We've had to look all over the place. We took a minority position in the FDIC's Corus structured sale to get insight into that space. We've asked ourselves whether we want investments of shorter or longer duration, and we think shorter durations are a better fit for the current market uncertainties we're facing. We've also dialed back our return expectations in multiple areas to better manage risk. In many cases, looking for levered returns in the 20% range is not worth the attendant risk. We're looking for transactions that are mutually beneficial. Who needs to transact and how can we structure a deal to help them? If you're looking at a life company loan, you have to consider the draconian effects of the mortgage experience adjustment factor (MEAF) on life companies' risk-based capital and be prepared to close before quarter-end to help mitigate that. If you're looking at a loan in special servicing, you have to understand the effects of the net present value calculations under the servicing standard and help the special servicer achieve a result that's defensibly in the best interest of the securitization trust. We may have all expected an 'RTC II' scenario where assets would drop into our lap at 50 cents on the dollar, but that hasn't happened. You have to be more creative than that. As for banks, you have to understand how they're affected by FDIC regulations."

Pat picked up that thread: "Banks haven't been forced to take quick action. It's as if the Administration were saying 'interest rates are close to zero—let them build up reserves for a few years and take another look at them then after CRE values have increased.' If all the bad loans had to be marked-to-market, there would be a thousand bank failures."

Trey returned to the theme of investor expectations: "We've all heard about '2x and 20' (referring to a 2-for-1 return of capital and an internal rate of return of 20% or more). That was a great idea a year ago, but deals weren't closed on that basis. Investors have had to confront the reality of yield compression or they've converted their strategy altogether. Most sense that the incremental risk you take on to get that 20% return is not worth it. They'd rather get 15-18% levered returns with less risk. In the distressed markets, the real story is the banks. Compared to CMBS, where assets are usually income-producing and there's an orderly disposition process intended to assure the best price for the trust, bank loans have shorter terms, are secured by largely transitional assets—land, construction projects and the like—and do not involve CMBS-type restrictions on dispositions. This is where the opportunities really are for investors. We've seen banks do some very creative things: joint ventures, A/B structures, and other recapitalizing strategies."

Asked about the effects of increased profits among money-center banks, Trey continued: "Adequate capital can allow them to make tough decisions. Last year we saw more maturity defaults. Now we're beginning to see monetary defaults. It's taken awhile for jobs to affect rent rolls. If borrowers can't pick up the shortfalls or provide additional equity, it forces everyone's hand. Banks are better positioned now to deal with that."

The discussion moved to the attention that commercial real estate gets in Washington, and what the latest policy signals mean for CRE. Pat recounted that two years ago, Congress had little appreciation for the differences between residential and commercial lending. He continued: "Over the last 12 months, there's been more attention paid to the commercial side. Still, the message is not without its contradictions. Congress may want banks to make loans as a policy matter, but bank regulators still view many bank portfolios as already overweight in real estate. The risk of government regulation, particularly when it effects a re-setting of the rules that private parties had relied upon, is viewed very suspiciously by investors."

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Circling back to distressed loan dispositions, Lindsey was asked about the effectiveness of loan auctions, including the prominent example of Eastdil's \$1 billion pool for LNR. "We look at the auction process on more of a one-off basis, rather than in bulk. Selling a defaulted loan is tricky in a REMIC structure. If we can foreclose and sell the REO, we're more likely to do that."

Pat followed up: "For CMBS, within the Pooling and Servicing Agreement, you have to follow a strict process. Certain parties have what's referred to as a "fair value option," but there are checks and balances associated with that to assure that the trust gets a fair price. That's one reason why investors are likely to see bigger discounts on bank loans."

And what of the approach of special servicers across the industry? Trey responded: "They are different and evolving. Specials have been hit with a fire hose of deals and many were just not prepared for it. Each has a different personality. Some are more eager to explore auctions, some quickly go the REO route, some are more amenable to workouts and extensions."

Bert observed that there was a misperception that special servicers would give away loans. "Even the LNR pool, big as it is, is really being sold on a one-off basis since loans can be individually bid. There's not the group discount that people think there is."

Our concluding post on the AK Real Estate Roundtable will look more closely at the re-starting of CMBS and the looming specter of financial regulatory reform.