BNA, INC.

REAL ESTATE LAW & INDUSTRY

BNA Employee-Owned Since 1947

REPORT

MARKET TRENDS

Quality Gets the Upper Hand as the Commercial Real Estate Market Bifurcates

BY BRAD CASE

The recovery in commercial property markets may well have started—but not for all properties. Instead, the market seems to have bifurcated into a higher-quality segment that may already be rebounding, and a lower-quality segment that still has a lot of misery left in it.

Whether you take comfort or not in the recent market signals, then, depends on how you got into the market in the first place. If you looked for quality and value—if you were willing to earn your returns—then you're sitting pretty: the worst, it appears, may well be behind you already. But if you rolled the dice on the chance for sky-high returns with no real work on your part, you're going down the tubes: the worst is probably still to come. (And, incidentally, good riddance.)

That's the summary of recent signals from several points of view. The earliest came back in early November, when David Geltner of the Massachusetts Institute of Technology's Center for Real Estate commented on the continuing free-fall measured by the Moody's/REAL Commercial Property Price Index (CPPI): ''Healthy properties, those that are not in distress, have dropped in price only about 33 percent from the mid-2007 peak, while distressed properties in the CPPI have fallen 56 percent.'' Geltner pointed out hopeful signs produced by MIT's Transaction-Based Index (''this is the strongest sign of a bottom that we've had in two years''), but noted that the asset universe for the TBI is dominated by higher-quality core properties whereas the CPPI is based on the entire universe of property transactions tracked by Real Capital Analytics—including many of the lower-quality, non-core properties whose values were bid up during the commercial real estate price bubble by shoot-the-moon, ''value-add'' and ''opportunistic'' private equity real estate funds.

Brad Case is vice president for research and industry information for the National Association of Real Estate Investment Trusts.

Bank of America/Merrill Lynch reinforced this perception in its Research Investment Committee Report, *Tails of the Unexpected*, which focused on the implications of market bifurcation for future returns of publicly traded REITs. ''Based on our proprietary analyses,'' observed BoA/ML, ''we determined that public REITs own a higher proportion of the best CRE in the US and therefore should trade at a premium to the US average. Institutional investors are chasing high quality assets, which are difficult to find—a trend that should benefit public REITs.''

Next, Green Street Advisors chipped in at the beginning of December with its new commercial property price index (also, confusingly, called CPPI), based on the information on net asset values and pending transactions that its analysts compile in the course of their company-level analyses. Green Street reported that the Green Street CPPI reached its trough in May 2009—down almost two years and some 39 percent from its peak measured in August 2007—but by the end of November it recovered to an aggregate loss of only about 33 percent.

''Caveats abound,'' Green Street noted, ''but there is no debating that a recovery in property values has commenced.'' As with the TBI, of course, the Green Street CPPI is based on an asset universe that—because it is restricted to REIT-owned properties—is dominated by higher-quality holdings.

The New Two-Tiered Market. Finally, Real Capital Analytics added its own analysis of ''The New Two-Tiered Market,'' finding that ''two vastly different markets are emerging for properties dependent largely on their ability to provide secure, stable cash flows—or not.'' This brief report, densely packed with insight, by itself gives reason for pleasant dreams among investors in high-quality CRE but sleepless nights among the value-add and opportunistic crowd.

The RCA report begins by noting dramatic differences in transaction prices for the different quality tiers: ''Properties considered 'core/stabilized' are achieving some surprisingly high prices. However, properties with vacancy, roll-over issues or deferred maintenance, the 'value-add/opportunistic' plays, continue to be deeply discounted.'' Pointing out that the capital market has provided ready capital for the better-quality real estate investors, while freezing out the fly-by-nights, RCA then digs deeper and sees that ''the motivation of buyers is also causing the dichotomy in pricing.''

''Buyers of core/stabilized properties are not as discouraged by the poor outlook for fundamentals since their assets are already well leased, insulating them from most near-term market troubles. They also realize that the opportunity to buy at relatively high cap rates with conservative but cheap financing is one that will surely not last. On the flip side, value-add/opportunistic buyers are still on the sidelines. The motivation of sellers is also part of the dynamics that have led to a two-tiered market. Sellers of core/stabilized properties have little motivation to sell currently. Even if they face a looming mortgage maturity, it is probable that the loan will be extended (for) now. Conversely, sellers of value-add/opportunistic plays are almost certainly distressed.''

What of the future? RCA points out that the policy statement issued jointly on October 30 by federal banking regulators ''will further promulgate the two-tiered market. It makes extension and modification easier for assets with cash flow; however, those assets with little to no cash flow are much more likely to face foreclosure and liquidation.'' Thus, the supply of value-add/opportunistic properties available for sale is anticipated to grow substantially.''

So Is CRE Still the Next Shoe to Drop? Bipolar CRE disorder is likely to confuse outsiders for several coming years, depending on whether they're observing the Jekyll of properties intended to be managed or the Hyde of bubble-era ''plays'' based on an opportunistic wing and a value-added prayer. Taking a step back, though, we might ask which personality is likely to dominate the health of the economy over the next few years. Thankfully, a thoughtful consensus is growing that, even as investors in value-add and opportunistic funds lose their collective shirt, the problems of the commercial property market are unlikely to bring down the financial system.

Jonathan Litt of Land and Buildings Investment Management, for example, released an *Outlook* on Dec. 7 focusing on whether commercial real estate will indeed be ''the next shoe to drop'' but answering with a reassuring ''we don't think so.'' Litt points out that the financial system is most vulnerable during the next three years, while the hopelessly bad debts incurred by value-add and opportunistic investors during the twin debt and CRE price bubbles will mostly mature outside that window of vulnerability. ''The vast majority of debt coming due (during 2010-2012) was underwritten between 1999 and 2003, before peak valuations, meaning today's valuations are likely actually higher than they were at origination and the loans are in the money.''

In summary, Litt notes, ''many owners and lenders are delaying the realization of losses with the hope that the economy improves or the bubble reflates, and right now both are working in their favor and will likely continue to do so for some time.'' The scariest time for highly leveraged commercial real estate investors, Litt predicts, will likely be from 2015 through 2018—but ''presumably most lenders are assuming a recovery in values and improvement in capital markets by the time these debts mature.''

Green Street Advisors reached a similar conclusion, arguing that the availability of capital to the higher-quality segments of the commercial real estate market will ultimately avert a wider catastrophe. ''To be sure,'' Green Street notes, ''the sector's problems, including declining cash flows and way too much leverage, are anything but trivial. Losses by lenders and owners will be both large and painful in coming years. The losses that lenders will take on this debt will cause bank failures aplenty and will put a big anchor in the ability of surviving banks to originate new loans. Still, what once looked to be a Category 5 whopper now looks like it will be less menacing by the time landfall occurs.''

In particular, Green Street notes that uncertainty, both about capital availability and about property performance, has come down dramatically—a fact not lost on REIT investors, who have seen its corollary, return volatility, plummet accordingly. ''The problem confronting commercial real estate,'' Green Street points out, ''though daunting, has now become quite simple: the sector is woefully undercapitalized. This, fortunately, is the type of problem that markets excel in fixing. Indeed, new capital has begun to flood into real estate, and there is plenty more behind it. The scarcity and high cost of mortgage financing probably mean that property prices will remain on the cheap side of a reasonable range for quite some time, but a calamity is unlikely.''

Finally, Bank of America/Merrill Lynch is noticeably more upbeat in its assessment, mostly because its focus is on publicly traded REITs rather than the private side of the CRE market. Although the bank channel is likely to remain inadequate for the broader market, it is not likely to stifle the opportunity for recovery and growth among the stronger investors with broader capital market access: ''It may take as long as 3-4 years before bank lending returns to normal spreads and capacity,'' BoA/ML notes. ''This should benefit public REITs given their generally better capitalized balance sheets (*post* the latest equity raises) as well as superior access to capital given their strong relationships with lenders.''

   ISSN 1944-9453

Implicitly, the BoA/ML outlook adds another dimension to the bifurcation of the real estate market by extolling especially those REITs with more defensive postures: lower leverage along with ''high quality properties in prime locations, resilient tenant mix, simple business models with predictable cash flows, and mature markets with stable growth characteristics.'' Although BoA/ML's mandate is to differentiate among publicly traded REITs, its analysis provides a compelling basis for differentiating the entire publicly traded REIT model from the value-add/opportunistic fund model with its now-miserable foundation of high leverage, lower-quality properties, convoluted business models, little if any attention either to tenant mix or to cash flows, and so-called emerging markets with so-called outsized growth characteristics.

''Although many REITs have now re-equitized, and we may be in the beginning stages of a recovery,'' BoA/ML concludes, ''a strong balance sheet through the cycle has placed REITs with these defensive characteristics in a position to be able to take advantage of growth opportunities. Maintaining a strong balance sheet is even more important if it takes another 3-4 years for bank lending to return to normal spreads and capacity.'' That could be an effective summary of the prospects for the entire CRE industry.