



# REAL ESTATE LAW & INDUSTRY



## REPORT

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### INDUSTRY PRICE TRENDS

## Market Bifurcation Widens: REITs Earn, Acquire; Private Funds See Clawbacks



By BRAD CASE

**R**eal estate investors who enjoyed a vacation last month missed little in the way of surprising developments. As school begins again, the forces that have defined and driven the real estate market for much of the past 18 months remain on full display:

- Overall property values continue to bounce along a “choppy bottom” that is likely to last for several more quarters.
- The overall figures continue to mask a market bifurcation in which higher-quality properties are recov-

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ering strongly while the bulk of assets are still weakening.

- Publicly traded REITs continue to generate good news, with dividend increases and anticipated stronger earnings on top of an active acquisition picture.
- In contrast, private-side real estate investment managers continue to generate bad news, with clawbacks and forced recapitalizations further discrediting the private approach.

### **You Call a 10 Percent Drop in Two Months ‘Choppy’?**

First, the overall market picture. Property values had increased strongly in May, leading some at that time to wonder whether the downturn was officially over. Not so fast, said the markets, which stunned observers by falling 4 percent in June, according to the Moody’s/REAL Commercial Property Price Index (CPPI), and by another 5 percent in July, according to the new CoStar Commercial Repeat-Sale Index (CCRSI)—on top of the CCRSI’s more dire 5 percent estimate of the June decline (See related article in this section).

Don’t read too much into those drops, though—just as you shouldn’t have read too much into the big increases measured for May. As Professor David Geltner of Massachusetts Institute of Technology’s Center for Real Estate said of the May CPPI numbers, “All in all I would still say we are essentially just bouncing along . . . in an environment that remains difficult and with an outlook that can hardly be called ‘rosy.’”

Responses to the June and July declines should be similarly measured, and generally are: Moody’s Investors Service said of the June CPPI-measured decline

that, “We expect property prices to remain choppy for some time as commercial real estate markets and the broader economy continue their slow recovery from the recession.” Meanwhile Professor Norm Miller of the University of San Diego’s Center for Real Estate (and CoStar’s vice president of analytics) said of the July CCRSI-measured decline that “right now all we can say is that we are observing a shaky bottom.”

**The Bifurcated Market Signals Its Distress Again.** Two factors are behind that severe “choppiness.” The first is still-slim transaction volume, which increases uncertainty and therefore volatility in monthly estimates: although Real Capital Analytics reported that July was “the second most active month this year,” transaction volume still remains not far from historic lows. The second is the influence of distressed sales—that is, which part of the bifurcated market dominates in any given month: CoStar noted, for example, that “since 2007 the ratio of distressed sales to overall sales has gone from around 1 percent to above 23 percent currently.”

Interestingly, Professor Sam Chandan, global chief economist at Real Capital Analytics, suggested on Aug. 23 that the increase in distressed sales may actually signal improvement in the real estate economy. According to this argument, lenders had previously been anxious to modify the terms on distressed debt because the alternative—putting the property on the market through foreclosure—had been so unappealing. The nascent improvement in market prices, though, has altered the balance: under more recent conditions, a distressed sale is more promising than loan modification (3 REAL 596, 8/24/10).

That hypothesis fits nicely with another observation from CoStar’s Miller, that “we’re seeing more distress for investment grade than for general real estate.” That makes sense because the investment-grade part of the market is where values have been firming up, while values for lower-quality assets have continued to soften. Green Street Advisors, for example, estimates that values of properties owned by publicly traded equity real estate investment trusts have increased by nearly 25 percent since their market bottom.

The paradox is that improvement in the market (at least for higher-quality properties) prompts greater transaction volume from the many distressed sellers of those higher-quality properties—and the predominance of distressed sales then produces a further deterioration in the average measured property value even as actual market conditions are improving. As RCA’s Chandan puts it, “On the margin, a property that a lender determined last year should be held as REO [real estate owned] or modified is now coming to market in a distress sale. If this is the case, then the rise in distress sales actually reflects that the market’s underlying price trend and capacity to absorb additional supply at higher market clearing prices is improving, even if the increase in the distress share itself is depressing the observable market price index.”

In short, increased transaction volume brings measured values more in line with the “shadow price”—that is, with actual but previously unmeasured property values. Transaction volume brings price discovery that reveals what had been hidden: the true values of properties owned by distressed real estate investors.

**Public Side: Acquisitions and Distributions.** Of course, for price discovery to take place somebody has to be in a position to take the favorable side of every distressed sale—and, in this connection, CoStar noted that “the most active buyers have been REITs.” The current market, in short, is exactly what REIT investors have been anticipating for 18 months: an enormous transfer of higher-quality assets from sellers whose luck (aka capital) ran out in favor of buyers who earned their access to capital. (That giant sucking sound you hear is the flow of assets from private equity real estate funds to publicly traded REITs.)

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At the same time, Mike Kirby of Green Street Advisors reported on Aug. 31 that one of the two main catalysts for the improvement in REIT-owned property values “has come as a big surprise amidst such a weak economic environment: the intermediate-term outlook for real estate fundamentals/cash flows is stronger today than it was a year ago.” REITs, that is to say, are accomplishing every investor’s dream: they’re buying properties at their market bottom, just as fundamentals are beginning to improve.

As a result, the picture for REIT earnings and distributions has also improved. Chris Henderson of SNL reported, in a pair of articles on Aug. 18 and 19, that “dividend cuts could be a thing of the past” while, so far in 2010, six REITs have reinstated dividends and another 28 have increased them. As Henderson noted, “As they issued equity throughout 2009, leverage on REIT balance sheets steadily decreased throughout the year. With pricing having also seen a strong uptick since March 2009, and most REITs hitting their estimates for the 2009 full year, many REITs seem to be focused on either returning to all-cash dividends or increasing their dividends in 2010.”

Green Street’s Kirby maintains a typically measured posture toward the future for REIT-owned property values: “The spread between private-market cap rates and corporate bond yields is about as large as it has been at any time since ’94 . . . Expectations for weak NOI [net operating income] growth explain a good portion of today’s unusually high spread, but it is still dangerous to underestimate the upward pressure that yield compression can place on values. After all, economic (after capex) cap rates averaging 6.5 percent in a world where 10-year Treasuries are generating a yield of only 2.5

percent provide a very large cushion for real estate owners even if growth disappoints.”

**Private Side: Sucking Wind.** Meanwhile, private-side investors are mostly shut out of this prospective growth. Preqin, for example, reported in its September Real Estate Spotlight that “fundraising in the first two quarters of 2010 has been particularly poor,” with the second quarter providing “the lowest quarterly fundraising total since Q3 2004. This steep decline in fundraising comes as a direct result of continuing investor uncertainty regarding the state of the industry and the estimated timescale for recovery.”

This is hardly a surprise, given not just the hypermagnified recent losses suffered by investors in private equity real estate funds but also their poor long-term performance, even on a risk-adjusted basis. Even those funds with “dry powder” seem to have given up deploying it—never mind that the market is at or near its much-awaited bottom—and retreated into a defensive, no-transactions-is-good-news posture: as Preqin notes drily, “In recent times fund managers have been calling up committed capital at a slow pace, and with transaction levels low, investors have not been seeing distributions from previous investments.”

What’s more notable is how deeply their performance seems, finally, to have discredited private equity real estate funds among their potential investors: as Preqin notes, “The 73 percent of investors (surveyed) being below their targeted real estate allocations shows just how pronounced the current feeling of uncertainty towards

the (private real estate) asset class is, with even those below target reluctant to commit to new vehicles.”

Of course, the continued trickle of poisonous headlines helps to perpetuate that “uncertainty.” The latest, courtesy of Bloomberg’s Miles Weiss on Aug. 27, focused on clawbacks—refunds of “performance” fees paid to fund managers for helping to inflate the commercial property price bubble—and the possibility that some investors may be out of luck even to that extent. Weiss quoted Geoff Dohrmann of Institutional Real Estate Inc. as warning that “some managers have had to write checks and some managers have had difficulty writing checks.”

Instead, the funds have been asking their investors to write the checks. August saw several new reports of private equity real estate funds shaking down their investors in recapitalization drives, accompanied by the threat that non-participants would see even more of their beneficiaries’ wealth eviscerated. According to a publicly available memo authored by Los Angeles Fire and Police Pensions, for example, one fund demanded a recapitalization with an eventual estimated “blended return of 31 cents on the dollar on old and recapitalization capital (10 cents on the dollar for non-participants).”

That fits with Preqin’s observation that “many firms have already taken the concept of fundraising to a new level, essentially remaining in fundraising mode on an almost perpetual basis.” But it’s not much of a way to attract investors, is it?