

Capital Synergies Podcast for Commercial Real Estate Investors
“2009 Outlook for Commercial Real Estate Investors”

DARBI: Hello, this is Darbi Worley, your host for the Capital Synergies Talk Show for real estate investors. Capital Synergies is brought to you by Steelhead Capital.

So today, guys, we have joining us Mr. Dan Fasulo, managing director of research for Real Capital Analytics. Dan is here to take a look ahead at the troubled commercial real estate market and hopefully, to give us a little insight as to what it is the investors might expect in the year ahead. Dan, welcome back to the show.

DAN: Thanks for having me.

DARBI: So, Dan, obviously at this point we are no longer talking about if the commercial real estate investment market is in trouble. But the question really is, how much, how much trouble?

DAN: Well, it's pretty difficult to sugarcoat what's going on right now. This is the most difficult time I've seen in my 10-year career as a commercial real estate analyst. The debt markets are very much tied up right now. There is a significant amount of dislocation in this space. And as everyone knows, the commercial real estate industry is an industry that relies on debt in its normal course of business. So it's not a surprise to me that the industry would be under a lot of pressure given the state of the financial markets.

The other thing that has happened obviously is just the tremendous pressure that the capital markets themselves have put back on the general economy. This downturn was kind of led by the credit crunch and the lag part of that was its impacts on the general economy so commercial real estate is almost getting hit again, if you will, by the impact of the space market fundamentals which are crumbling in some parts of our industry.

Right now, we're seeing vacancies rise rapidly in certain markets and for certain property types and we're seeing rents fall significantly for the first time. The one

bright spot we were kind of alluding to in early 2008 was the fact that yes, the capital markets are frozen up but, hey, the space markets are still good. There's still tenants paying rent, occupancies are good. But that trick is up. And now, tenants are going bankrupt in the office sector. In the retail sector, we have a big list of retailers that are going out of business. And at the end of the day, it puts a lot of pressure on commercial real estate owners.

DARBI: All right. So let's take a look at the major property types. You know, we look at the office, retail, apartments and industrial. Which of those in your opinion is taking the hardest hit right now?

DAN: Real Capital Analytics is the firm that tracks commercial property sales. So we figured out really quickly that we needed to shift gears in order to remain relevant in the marketplace.

So in this fall, we began not just tracking property sales, which there are fewer of, but we started tracking distressed properties, whether they were sold or not. Basically, we told our entire analyst team to track these properties and what we found so far is the biggest exposure to potential distress exists within the retail and office sectors followed by apartment and hotel. And it makes sense when you think about what firms have been greatly affected by the recent economic slowdown, whether it's the financial firms which are tremendous space users or under a lot of pressure because of the credit crunch, or whether it's retailers that have been just unbelievably impacted by the slowdown in consumer spending in this country. So it makes sense that those two property types would kind of be at the top of our list for the distressed. That's not only here but will be coming this year.

DARBI: Yeah, I tell you just walking around New York City, I hate to say this but it seems like almost everyday, I'm noticing a new empty storefront. You know, it's

frightening. So let's talk a little bit about the apartment sector. What in your mind are going to be the most critical benchmarks for investors in 2009?

DAN: It's hard to make general comments about the apartment sector because you really need to look at it on a regional basis or even a market-by-market type of basis before you can make a general statement. The conditions that exist in the New York City metropolitan area are completely different than the factors that are impacting the market in Phoenix, for example.

That being said, apartments already are probably the property type that's the most far advanced into the distressed cycle. If you remember, apartments are the most closely related to the housing bust that happened a couple of years ago now, and the kind of the first impacts we saw on the commercial property side was the fact that many condo conversion or attempted condo conversions fell apart in late '06 and throughout 2007 and then 2008. And we've seen a lot of those failed condo conversions already resell to a healthy party so I think whereas we might be in the first few innings for property types like office retail, I think we're in the middle of the game for the distressed cycle for apartment properties.

And I think as long as investors do their homework on a market-by-market and even a property-by-property basis in 2009, I think with the availability of GSC financing, I think there's some tremendous opportunities in the apartment sector right now.

DARBI: This may be an ill-informed question but it seems to me if home foreclosures are up, that would seem to indicate that apartment rentals would go up as well. Is that not the case?

DAN: Yes and no. Again, it goes back to the market-by-market situation. It depends on how much those foreclosures or those single family homes that are vacant really

go into the general rental supply. If all of a sudden there's a hundred homes in your neighborhood that are available for rent, obviously it's going to have an impact on a rental apartment community down the street as far as what type of rental rates they can achieve. So it's very much a market-by-market type of situation.

DARBI: Okay. So according to one of your recent reports, the volume of potentially troubled commercial properties, including those with loans maturing in 2009, could top more than \$80.9 billion. What is your take on this situation?

DAN: You know, that's actually a conservative figure as well.

DARBI: Really.

DAN: When we put together this troubled asset program, we were very careful not to go willy-nilly marking every property troubled. So we do have a strict methodology as to what we consider a troubled property.

Some of it resolves at the property level if a potential tenant is going bankrupt. Some of the trouble, actually a lot of the troubles at the ownership level where there might be an owner who overleveraged an asset and now is facing the refinancing risks and finds themselves underwater and in a situation where they need to get very creative in order to keep the property, whether to take on some new equity partners or to basically write a big check to stay afloat. And not every owner has the ability to write another check to keep their property above water.

So a lot of properties with the 2009 refinancing risks are winding up in our potentially troubled bucket and if we find that refinancing is not going to happen and an owner is going to wind up in the foreclosure process with their lender, then it would move from our potentially troubled bucket into our troubled bucket, or

potentially lender REO when the lender actually takes back the property. However, on the flipside, if a miracle does happen and an owner can work out a situation where an asset can be refinanced, that property will be taken off our potentially troubled list.

But as of now, based on the kind of the capacity we see in the debt markets right now, there's just not enough capacity to handle the amount of refinances we have in this industry in 2009. And that's kind of why there were some powerful folks in the real estate industry, down in Washington, D.C. over the past few weeks, probably begging our case to the federal government that we need some support at a certain level. I don't think anyone wants to bailout anyone who's overpaid and overleveraged. We don't want to bailout those folks but we just want someone who has a normal healthy asset with stabilized cash flow and tenants that are paying rent. We want that owner to be able to refinance his property and when that is in jeopardy, we don't have a functioning market and that's when the government needs to help out.

DARBI: So are you seeing investors then becoming tunnel-visioned in regards to the troubled assets? And do you think that this will prevent the return of a more traditional sales volume and additional transactions?

DAN: Well, let's face it. I mean, we're not going to have a normal market until the distressed market gets cleared up. You know, you as an investor are not going to be buying something retail if you can buy something down the street for wholesale price, right? And it's going to take months if not a year to really clean up the distress that's in the market. One good thing about our program that we initiated here is we're going to be tracking the trouble on these properties over time and we'll be able to communicate to the market when a property does get resolved and a healthy third party comes in and buys the assets. Hopefully, we'll

be able to communicate when we kind of see the cycle turning, if you will, where there's less and less troubled properties available for purchase.

DARBI: So speaking of the potential return to “normal” in commercial real estate, do you feel like the rules have been changed permanently by the past year of inactivity? Or is there hope to return to normal?

DAN: I guess it all depends on your definition of normal, right? I mean, life did exist before there was a CMBS market. Will the CMBS market come back at some point? Yes. When it does come back, it'll come back in a much more conservative format but in my opinion, at least I think it's a very healthy way of distributing debt around to people who can take the risk. But losing that source of capital has just made kind of the sales volume levels we were at over the last couple of years completely unsustainable for the future.

The future will kind of plateau at a sales level of maybe \$100-200 billion worth of commercial property sales a year in the U.S. whereas top of the market in 2007, we did a half a trillion worth of property sales. In 2008, we're going to wind up with about 150 billion worth of property sales. However, like 55% of that was done in the first half of '08. So I think it's going to be a long time before we return to the record levels of activity that we saw in 2007, not only on the sales side but also on the pricing side.

DARBI: Okay. Now, what role did the banks play in all of this, in terms of capital availability and the loosening of the credit? Where do the banks fall on that? What is their responsibility?

DAN: Well, I mean at some point, if you're a bank, your core business is lending money, right?

DARBI: Right.

DAN: But right now, everyone is in kind of a protection mode, if you will, and no one wants to make a bad loan right now and I think that many are waiting for the economy to stabilize or at least some signs that the economy is stabilizing before they put out any more money, especially there's many lenders who feel they have enough exposure to the commercial real estate industry as it is already and they don't need any more. That being said, I think lenders will continue to work with their best clients, especially on the refinancing side this year and there will be money available for good assets and healthy owners. But I think on the margin, there's just going to be a tremendous a lack of debt financing for our industry in 2009 and it's going to create a situation that puts a lot of pressure on certain owners and certain properties and at some point, it's going to basically inflame all the distressed assets that are available for purchase by investors.

DARBI: Okay, well, let's talk a little bit about the government and where the government falls in. Turning first to the efforts by the government to bring interest rates down, how has that affected commercial real estate?

DAN: Yes. I mean, it's kind of a little different ball game between commercial and residential. We've seen rates fall dramatically in the residential side but I think at some point, it widens the spread of profit for a lender, right? Because their cost of borrowing goes down. So at some point, a lender is going to find that spread too attractive to pass up and the money is going to be put out to the market again. But whether it happens next month or in six months, I don't know. I think at this point, everyone is too worried about the economy to let the potential profit to blind them to the realities of fundamentals and where they're going to move over the next 12 months. It doesn't matter what your spread is on the loan you're making if next year, the property you made the loan on isn't performing, right? Now, I think everyone is just taking a wait-and-see type of approach.

DARBI: So when you say wait and see, is one of the things they're waiting on is for Obama to be sworn in? And what do you see in terms of what you're hearing out of Obama and his plans for the economy? How is that affecting the market?

DAN: I think it's definitely affecting the market tremendously. Not necessarily because Obama is not going to do the right thing but I think it's the uncertainty of what's going to be done more than anything else that's holding up the market. And I think it makes sense to me for the new Obama administration to put the rules in place as soon as possible. Investors don't like to play unless they know what the rules are and if you're a bank and you're sitting on bad assets or bad loans, you're not going to sell them for pennies on the dollar if there's a chance the government is going to buy those assets from you for 50 cents on the dollar, right?

So right now, the transition in government and the government's inaction or at least the government not communicating what they're going to do, is creating stagnation in the market. At some point, I don't even care what they plan to do but they need to communicate. Either they're going to help or they're not going to help and at least at that point, investors will know what the rules are. And at some point, investors will capitulate and say, hey, all right, I'm not getting helped out by government which is get rid of the stuff for nothing, all right? And then, that's when it starts the healthy market again. So it's the uncertainty more than anything else on what is going to happen that's holding up the market.

DARBI: Sure. Now, what about these recent changes in the stock market then? Has any movement in the stock market indicated to you that there might be a lessening of this concern investors are feeling?

DAN: Well, I guess I'll speak to the REIT market because it directly relate to commercial property. This significant disconnect between pricing in the REIT

market and the prices for just commercial properties the way they're priced right now. If I'm an investor, I'm saying to myself, why do I buy a property that's for sale on the street at a 20% discount if I can just buy a REIT stock at a 50% discount and wind up as the owner of properties that way. So I think that disconnect is another thing that's going to need to be cleared up before a healthy property sales market returns again because either REIT stocks need to come up in value or property prices on the direct market need to come down significantly and I think we're going to see a little combination of both in 2009. The public market always have a tendency to overreact and I think they might have done that with the REIT companies this cycle.

DARBI: Okay. So speaking of looking ahead into 2009, what surprises if any do you see on the horizon? And what should our listeners be looking out for? What are some closing words of caution or advice that you can share with our audience?

DAN: Well, you know, it's going to be a challenging year. I think anyone who has the opportunity to take the year off, God bless.

DARBI: A good time for a beach island somewhere?

DAN: Yeah. That being said, I think the investors who are not stuck looking backwards, plugging holes in their portfolios. The investors that don't have those concerns of looking backwards, I think for those, there's going to be great opportunity in 2009 to take advantage of the dislocation. If we go back in time and look at the years of 1992, 1993, the kind of the depth of the last real estate recession, the investors who bought properties in those two years saw returns that are off the charts. Now, I can't tell you that 2009 is going to be that year but I tell you from an income perspective, property values and the opportunity is looking more attractive to me than it has in many, many years. I'm not shaking my head as much as to some of the prices being paid but at some point, investors need to take the plunge and not

be worried about their assets falling another 10% to 20% in value. I think the real winners are going to be the investors who can pick up assets and plan to hold them for five to seven years. I also think this is going to be the year of homework. You know, you can't just make a blind blanket bet on a particular market or particular property type. I think investors really need to do their homework on a market-by-market, on a property-by-property basis in order to really find the opportunities that are out there.

DARBI: Okay. So speaking of homework, where would you advise our listeners to go to get more information on these critical trends in commercial real estate?

DAN: Well, there's a bunch of free data on the commercial property market and our new distressed product on ranalytics.com and they can certainly send us an email or give us a call, we'd be happy to walk them through what's available.

DARBI: Great. Well, Dan, thanks so much for joining us. I know that now more than ever, our listeners appreciate hearing from someone that's really as close to the action as you are. We hope to have you back again soon with an update and we wish you and everyone at Real Capital all the best in the new year.

DAN: My pleasure. Thanks for having me.

DARBI: All right. So if you are an investor looking for guidance in the acquisition or disposition of commercial real estate, be sure and check out the investment advisory services offered by our sponsor, Steelhead Capital. Just go to www.steelheadcapital.com and request your no obligation portfolio review.

This has been Darby Worley, your host for Capital Synergies.

Thanks for joining us. *[End of Transcript]*