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NORTHEAST REAL ESTATE BUSINESS

GREED GETS ITS GROOVE BACK

Buyers, banks and sellers come to terms with market conditions, driving an uptick in real estate transactions.

By Herman Fala and John Schwartz

Fear and greed. To paraphrase Emeritus Professor Peter Linneman at The Wharton School, these are the yin and yang of commercial real estate cycles, the opposing psychological forces that dictate the direction of the industry.

On the upstroke of a cycle, greed is the dominant force while fear goes into hiding. We saw this all too well in 2005 and 2006. No one feared that his projections might not come to fruition or that cap rate compression might not last forever. The cycle had lasted so long that many young traders and market makers had never even seen a bad deal or a defaulted loan.

After the bankruptcy of Lehman Brothers and other institutions in the fall of 2008 and the concurrent collapse of the capital markets, fear routed greed and took control of the commercial real estate markets. Lending activity was paralyzed. The CMBS money machine dried up. Detached from this source of quick and easy credit, traditional commercial real estate transaction activity ground to a halt.

For the better part of the last 4 years, fear has dominated the commercial real estate playing field. Even when folks began thinking about doing transactions, capital sources were few and deal risks seemed insurmountable. The over-leveraging of assets that occurred during the boom years precluded the closing of transactions.

The challenges of resolving underwater real estate assets formed an insuperable hurdle to any sort of stable market. How can you sell a building that was purchased for $50 million, has mortgage debt of $45 million, is now worth $40 million, and can be financed for only $25 million?

As the market began to move, capital sources and high-net-worth individuals pursued fully leased trophy office buildings and multifamily apartments in prime locations. As pent-up capital chased cash-on-cash yields as low as 4 percent, prices for the most attractive trophy properties and multifamily portfolios became quite frothy.

While the competition for limited trophy properties was fierce, the non-trophy properties — which make up the bulk of commercial real estate and hold the vast majority of the industry's value — were being ignored.

Some investors attempted trades of non-trophy assets but often aborted because the complications of dealing with deleveraging, defaulted loans, bankrupt tenants, underwater mezzanine positions and other challenges became too daunting.

Sellers clung to unrealistic values. Lenders wouldn't budge. Expectations did not match the realities of existing commercial real estate values, lender requirements and other market conditions outside the circle of trophy properties.

So, where are we now on the spectrum of greed and fear? While it may be too early to declare a comeback, an uptick in commercial real estate transaction activity over the last 6 to 9 months suggests that greed may be making a comeback.

Most industry participants have concluded that we have reached the bottom. Hardy bidders are showing interest in challenging transactions. The players in the commercial real estate space have come to grips with the realities of the new playing field and current market valuations, and have decided, still somewhat tepidly, to put their capital at risk once again.

Lenders holding distressed mortgage loans are more likely to take decisive actions, accepting realistic prices for their loans or their foreclosed properties. Investors are also recognizing the need for higher equity requirements. Moreover, the debt financing sources are relaxing some of their underwriting criteria and loan pricing in order to get deals done.

Much of the evidence for these trends is anecdotal, but some hard data confirm that the "fear index" is receding. The interest rate pricing on new CMBS loans has dropped below 5 percent, and the rate spreads of the recent CMBS deals over the prevailing rates on U.S. Treasury obligations has dropped significantly. The level of these rate spreads is often viewed as directly proportional to the perceived risk involved in real estate investments, so a tightening of spreads reflects an increase in market confidence and a reduction in fear.

But acquisitions and dispositions are still not for the faint of heart. Most current transactions involve the same challenges of distress and deleveraging that thwarted participants in 2010 and early 2011. The property that you want to acquire is probably the subject of a defaulted loan, and perhaps a defaulted mezzanine loan, so you will now have the additional challenge of negotiating a discounted purchase or payoff of the senior mortgage and the mezzanine. And did I mention that the special servicer is now in charge and there is a court-appointed receiver operating the property? Should you purchase the defaulted loan and foreclose against the property? Or should you seek the cooperation of the current owner, at a price?

The potential complications are endless. The partners within the selling entity do not see eye to eye, and you may have to negotiate with different factions. There are mechanics liens from unfinished construction work and there are tax liens against the property. And the lead tenant has just moved out of the building — is that a problem or an opportunity?

In the current market, there is no room for a real estate investor to get rich quick on financial engineering. Instead, success can be reached only through good old-fashioned real estate skills: underwriting correctly; being able to navigate the difficult multi-party negotiations, often with creativity and sound legal counseling; being able to reposition and re-lease a property as needed. In short, knowing how to extract value by applying a little elbow grease.

The fundamentals of supply and demand have not come back to anywhere near pre-recession levels. But assets are trading. Capital is available for the right transactions. Participants are starting to believe that they may be left behind if they fail to take risks that others are now willing to take.

We may look back at the fall of 2011 as the point when greed got its groove back.

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