

## **Is Capital No Longer the Problem?**

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The major problem for the real estate economy in 2011 is not capital availability but job growth. This is one of the key conclusions from the 17th annual ULI McCoy Symposium on Real Estate Finance, an invitation-only meeting of 35 real estate capital markets leaders held December 13, 2010, in New York City. While the real estate capital markets are not back to normal, there is considerable evidence that capital is going back to work wherever feasible. The problem is the *feasible* part, as the economy and job growth continue to move forward at a lethargic pace, limiting investment opportunities and improvements to real estate fundamentals.

### **Banks: Gloom and Doom Lifting**

Perhaps the most important development of 2011 is that many banks have recovered considerably from the ordeal of the past two years. The larger banks seem to be able to attract capital and have moved up the watch list. Smaller banks still have problems and cannot raise capital, and some are now being bought by other banks.

The FDIC has taken over many failed banks and did 18 structured transactions in 2010 to successfully sell many of these bank assets. However, it is more difficult for the FDIC to sell these bank assets today because of the new competition from operating banks that are selling assets or being sold themselves. Prices for assets went up through 2009 and into 2010, but have not risen much since.

A considerable supply of assets has come onto the market in recent months, and there may be some buyer fatigue due to the perception that there has been some overbidding on assets. Many of these transactions involve equity buyers of debt. The FDIC has also started a securitization program. But in general, deal flow still remains slow.

For many banks, it is a good time to be a lender because the cost of capital is very low and most assets seeking new debt capital are now fairly valued in the market and are not likely to see further major value declines. Nonetheless, overall lending is down from previous years, due in part to limited demand. However, banks are aggressively pursuing the corporate and REIT lending market.

Development lending is not happening for the most part, and any large-scale construction lending will require a great deal of equity. A couple of banks could come together to fund major

deals if the situation were right, but most banks will not touch spec construction today. Many banks and other lenders are not underwriting to appraisals but rather to debt yields because appraisals are not viewed as very relevant today.

“Extending and pretending” will continue, but with some increasing foreclosure activity. Major bank stocks have recovered and can now take the hit on more writedowns, and there is a great deal of bank debt product getting ready to come to the market.

### **Life Companies: Increasing Activity**

Life companies have very low loan delinquency rates and have been doing their part to increase lending. They are clearly aimed at high-quality core assets and have done a lot of lending in New York City and Washington, D.C. Because CMBS volume is much diminished, life companies have found the competitive landscape to be quite attractive. Life companies have been able to beat Fannie Mae on multifamily loans in the current market.

Once outside of core, there is not much lending, trading, or liquidity, though there has been some widening of life-company appetites for risk in recent months. Some life companies are starting to look at lending on unstabilized properties for 2011 and are crafting new strategies for entering that market.

Life companies prefer to lend where there is substantial and solid equity behind the asset, and most insurance companies prefer not to lend where mezzanine debt is involved, eyeing real equity from the borrower. In general, in most cases what the life companies decide they want, they get. Life companies currently will go as high as \$350 million on a loan for one asset; club deals could go higher.

Debt yield measures—the ratio of NOI to debt on a property—are running from 15 to 10 percent, and as low as 9 percent for multifamily. Typical loan-to-value ratios are around 55 to 60 percent. Spreads on the really low-risk assets are expected to narrow because these spreads are higher than those for other types of debt. The reemergence of the CMBS markets in 2011 and 2012 could change underwriting and pricing, bringing spreads in and increasing competition.

### **Public Debt Sector Reemerging**

The CMBS sector is emerging from its near-death experience. Everyone is trying to get something done now, and in many ways the market is already back to early-2007 aggressiveness levels when most had only hoped for something more modest, like a return to 2003”?

CMBS players will do deals with 75 percent LTV for five-year loans, with spreads of 200 to 300 basis points.

New proposed regulations are a concern for the CMBS sector, but if final regulations require risk retention, most CMBS lenders will have a work-around. Many CMBS lenders do not want to see risk retention rules, but many long-term lenders, such as insurance companies, would like to see risk retention in the market. The real cost of risk retention could be quite small, with some suggesting it may be as little as 12 basis points. The Dodd-Frank rules on this issue are due in April.

The problem that remains is that even with loans being made at 65 to 70 percent LTV ratios, many will ask, "What am I going to do with my 90 percent loan that needs refinancing." Many assets are overfinanced and need new equity. One result of this is that the mezzanine sector is active because there is demand to fill equity gaps in assets being refinanced.

Mortgage REITs have also been active and are expecting to bid on pools of loans from regional banks coming onto the market.

### **Private Equity: Core, Demand, and Frustration**

Equity investors have been actively pursuing high-quality core investments, and the availability of both equity and debt capital for these investments is considerable. Distressed assets have seen less activity than anticipated, leading to some frustration for opportunistic investors.

For many investors, capital is no longer the problem. The issue is who will lease the space. The only places where this is not the case are Washington and New York City, largely due to government largesse. The deal flow is higher in these two markets than anywhere. Cap rates are down for core assets, and it is apparent that cap rate compression is back.

There is still a plethora of distress and imbalances in the market, but not much deal flow. Pressure in the market is leading to more value-add transactions, but the question for many of these assets with high vacancies is where the demand will come from. Consolidation of space is taking place in the office market, with moves to more efficient space often resulting in less space needed for the same number of employees. This should give pause to office investors in secondary locations. Several sectors have offered above-average returns over the past year, including apartments, hotels, and housing for seniors.

For noncore assets, the question is how to value a partially vacant asset today. Even for core, there are concerns on this issue. Investors increasingly are liking what they have, and holding is now viewed as a good strategy.

Weight of capital is an issue again, and a great deal of global capital remains looking for yield across the world. From a global perspective, the United States is generally viewed currently as one of the best real estate markets for core investing. Sovereign-fund and offshore money is there waiting for core, but it is brutal raising new money for opportunity investing. A principal concern for core investors is the very low cap rates now governing core investments. Core investing may well be the wrong thing to do today because everyone is doing it.

For investment managers, there will be consolidation among private managers of money, and there likely will be little growth in this business.

### **REITs in Strong Relative Position**

REITs have performed well over the past year, and many have been able to raise substantial amounts of new equity and debt capital. Many investors in the market are looking for real, hard assets, including commodities and real estate, which has benefited the REIT sector. REIT funds have seen high levels of net new flows, all coming from institutional investors rather than retail investors. These are not invested on fundamentals but on a larger view of asset allocation. Real estate is in the way of capital flows, and rising interest rates could accelerate this. Capital flows into REIT ETFs are higher than ever before.

New REIT IPOs are on the way, but it is still difficult to do a REIT IPO. It is likely that there will be a lot of consolidation in the REIT sector. With all the regulations, it is increasingly difficult to be a small public company, and investors do not want small REITs, so most new IPOs will be sizable. Ten to 15 real estate firms are on file to go public currently, and probably three or four will launch in early 2011.

### **On the Mend**

The consensus of the McCoy participants was that the real estate investment market is alive and well, mending fences and anticipating that the economy will improve slowly. The weight of capital that drove the market in the prerecession era has not disappeared and is now pressing heavily on core assets, driving up prices. Investors still like core real estate, even when fundamentals are not good, which is a positive indicator that one can hope will lead to a full recovery for the industry in the near future. However, it will be some time—years—before the overall commercial real estate market is back to a healthy state.