

GUEST COLUMN

2011: CRE Markets To Focus On Wealth Preservation

By Robert Meulmeester & Neil Axler

As 2010 draws to a close, it now appears that the U.S. economy is experiencing neither a V- nor a W-shaped recovery. What best describes the trajectory of this cycle is L-shaped. Let's face it: Our economy seems adrift near the bottom of this cycle without any clear indication of where the market will turn next.

The significance of broader economic trends for the commercial real estate capital markets cannot be overestimated. Both economic fundamentals and prospects aren't particularly encouraging. Faced with persistent governmental indecisiveness related to any meaningful financial and fiscal regulatory reform, the U.S. continues to carry massive piles of debt. While none can dispute the existence of this debt—much of which resides on the balance sheets of our largest banks—nobody knows if, when or how to restructure it.

Against this backdrop, the proverbial tsunami of non-performing commercial real estate loans has yet to collide with the shore. It appears far out at sea thanks to concepts such as extend and pretend, delay and pray and kick the can down the road. These euphemisms are likely to spawn newer ones, too.

While it is difficult to derive much newfound optimism, commercial real estate transaction volume and asset values in 2010 seem to have rebounded for certain core real estate food groups since 2009. And if these numbers are nowhere near the levels recorded during this last decade, that may in fact be an encouraging sign that the market is not heating up irrationally. Even though bid/ask spreads have contracted somewhat, debt capital is not necessarily inexpensive and also remains restrictive.

Most debt currently exhibits wide spreads and unfavorable loan-to-value and debt coverage ratios. The latter is notably true in cases where the property cannot be financed through government-sponsored enterprises such as Fannie Mae or

Freddie Mac. In addition, equity capital is rare and remains expensive when benchmarked against risk free rates.

This brings us back to the fundamentals of today's quest for wealth preservation rather than a focus on irrational exuberance before the credit crunch and the Great Recession. Accurately gauging and adjusting risk is the new norm, rather than banking on the side of exuberant optimism. Conceptually, investors now expect to secure longer-term property income growth. Analyzing the future strength of that income stream is captured in the spread between an asset's income return (such as the average capitalization rate) and the risk-free rate, which is typically tied to the yield on 10-year Treasuries.

Today's pattern of spreads is approximately 400 to 600 basis points when comparing average capitalization rates over 10-year Treasuries for all property types. These high spreads are somewhat similar to the 2001 to 2003 era when the leasing market was impacted by rising vacancies and falling rents. Conversely, spreads were much lower during the boom years in 2004 to 2007. What's puzzling, however, is that average capitalization rates are lower today than they were from 2001 to 2003, and they have been trending down again since 2009.

Although some of the capitalization rate compression is clearly a function of those few bid-up core assets (as the product of excess capital chasing too few deals) the much larger pool of real estate collateralized by the many non-performing loans has yet to reach the market.

The wild card is whether interest rates will remain low on an historical basis considering massive deficits and growing refinancing needs at the federal level. It is more likely to foreshadow a rise in Treasury yields, assuming that investors perceive an increased level of risk. If you look at sovereign debt issues around the world, this has already materialized and has in turn driven up bond prices. Further, considering those non-performing loans and investor's

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requirements for risk-adjusted returns within the constraints of the new normal, it therefore appears likely that capitalization rates will begin to rise.

Both the cost of debt and equity capital will be influenced by these forces. Therefore, the need to repair and optimize the debt and equity structure of many assets becomes imminent for those owner/operators whose properties may be performing but appear to be overleveraged.

So what do we see as a solid commercial real estate asset class for 2011 and beyond? Again, since wealth preservation is now the chief focus for most investors, we believe that the preferred asset class will be multifamily. Outside of any specific asset class, the next best opportunities will lie in recapitalizations and restructurings. Those best positioned to leverage these opportunities will be strong owner/operators holding non-core real estate assets. These players must be willing to give up equity while their lenders should be ready and willing for a discounted pay-off in the hope of avoiding

foreclosure hurdles.

No matter who the investors are, however, certain best practices must be followed. First, owners must pursue a holistic yet detailed diagnosis of their holdings at the portfolio level. Then they must conduct the proper valuation and assessment to fully gauge their risk/return threshold. Only after these steps have been taken and additional due diligence has been conducted can CRE investors follow the path of wealth preservation.



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Recent Loan Transfers To Special Servicing

The following is a list of loans included in commercial mortgage-backed securities deals that were recently transferred into special servicing.

Property Type	Loan Name	Deal ID	City	State	Zip	UPB	Maturity date	Date xferd to S/S
Hotel	Longhouse Hospitality Pool	WBC07W08	Various	Various	Various	\$165,000,000.00	6/9/11	10/26/10
Hotel	Fairmont Sonoma Mission Inn & Spa	BACM0601	SONOMA	CA	95476	\$55,000,000.00	2/1/11	10/27/10
Hotel	Hilton DFW	GSM206G6	GRAPEVINE	TX	76051	\$45,501,937.80	1/6/11	11/17/10
Hotel	Marriott - Williamsburg	JPC06C15	WILLIAMSBURG	VA	23185	\$34,053,043.38	6/1/16	11/18/10
Hotel	The Suites at Mainsail Village	MLT06C01	TAMPA	FL	33634	\$26,569,805.26	2/1/16	11/16/10
Industrial	Summit Ridge Business Park	WBC06C25	San Diego	CA	92121	\$16,539,320.81	3/11/12	11/23/10
Industrial	Lexmark Distribution Center	PMC201R1	Seymour	IN	47247	\$13,976,803.03	2/1/11	11/10/10
Industrial	West Park Building One	BAFU0103	Hampton	VA	23666	\$8,803,173.57	3/1/11	11/16/10
Industrial	West Park Building Three	BAFU0103	Hampton	VA	23666	\$8,803,173.57	3/1/11	11/16/10
Industrial	Irwindale	JPC06C14	IRWINDALE	CA	91706	\$8,800,000.00	1/1/16	11/19/10
Multi-family	Empirian Multifamily Portfolio Pool 1	MLT07C01	Various	Various	Various	\$384,750,000.00	6/8/17	11/11/10
Multi-family	Empirian Portfolio Pool 2	MLCF0708	Various	Various	Various	\$335,000,000.00	6/8/17	11/30/10
Multi-family	Empirian Multifamily Portfolio Pool 3	MLT07C01	Various	Various	Various	\$330,250,000.00	6/8/17	11/11/10
Multi-family	Broadway Portfolio	CSM07C02	NEW YORK	NY	Various	\$70,000,000.00	2/11/14	11/2/10
Multi-family	The Highland and Lodge Pool	WBC06C23	OVERLAND PARK	KS	Various	\$45,887,534.82	12/11/15	11/19/10
Office	1900 Market Street	CSM06C03	PHILADELPHIA	PA	19103	\$63,120,000.00	6/11/16	10/25/10
Office	Plaza Squaw Peak	MLCF0705	PHOENIX	AZ	85020	\$50,000,000.00	12/8/16	11/19/10
Office	ONE OLD COUNTRY ROAD	BACM0506	CARLE PLACE	NY	11514	\$49,026,180.72	7/1/15	11/12/10
Office	St. Joe - Windward Plaza	JPC07L12	ALPHARETTA	GA	30004	\$47,634,792.00	7/5/17	11/16/10
Office	Baldwin Complex	CMAT99C1	Cincinnati	OH	45202	\$42,249,627.56	7/11/13	10/25/10
Other	Colony IV Portfolio - I	JPC06LD9	Various	Various	Various	\$67,290,000.00	12/1/11	11/30/10
Other	Colony IV Portfolio - III	JPC06LD9	Various	Various	Various	\$59,730,000.00	12/1/14	11/30/10
Other	Colony IV Portfolio - II	JPC06LD9	Various	Various	Various	\$44,340,000.00	12/1/13	11/30/10
Other	BTR Capital Portfolio	MLCF0602	Various	MD	Various	\$29,415,472.81	3/8/11	11/22/10
Other	Park 100 - Portfolio	LBUB08C1	INDIANAPOLIS	IN	46278	\$17,450,000.00	12/11/17	11/23/10
Retail	Simon - DeSoto Square Mall	MLT05MK2	BRADENTON	FL	34205	\$63,087,003.90	7/1/14	12/3/10
Retail	Colonial Mall Myrtle Beach	WBC06W07	MYRTLE BEACH	SC	29572	\$47,199,999.99	12/15/10	11/24/10
Retail	Lichtenstein Retail Portfolio	GMAC00C3	Various	Various	Various	\$25,455,238.94	11/5/10	11/19/10
Retail	Palmer Crossing	CSM07C03	Sarasota	FL	34233	\$21,300,000.00	5/11/17	10/19/10
Retail	The Bridge	CD06CD3	JENKINTOWN	PA	19046	\$18,101,000.00	5/11/16	10/26/10

Source: Realpoint, LLC

For more information, go to www.realpoint.com or call (800) 299-1665