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US Real Estate Capital Market Commentary: December 2011

"Repetition of the same thought or physical action develops into a habit which, repeated frequently enough, becomes an automatic reflex" – Norman Vincent Peale

2011: the tail-risk of deflation…

Despite the growing number of news stories about rising consumer prices, the global economy is stuck in a deflationary cycle. Economic output is stagnated and growth drivers are uncertain while regulation and protectionist trade rhetoric are increasing. In their well-intended effort to kick-start economic growth, central bankers and government officials around the world have pursued extremely loose fiscal and monetary policies. However, since this is a balance sheet-driven recession, these policies are having little effect on economic growth. The banking system cannot expand until it is fully recapitalized by replacing weak assets with fresh equity. Investors cannot make new investments without trust in the banking system and a positive consensus on economic growth.

Put simply: economic stagnation exposes investors to significant "tail risk". For real estate, deflationary tail risk is manifested in low cash flow growth and unlikely disposition prospects in the future. The investment market therefore remains sluggish with a yawning gap between equity return expectations and offered returns in the market. Subsidized interest rates and Keynesian spending are taking their toll on Sovereign risk and, by extension, bank credit profiles. While this is putting negative pressure on the financial system and economic outlooks, it is sowing the seeds for opportunistic investments.

As such, we have seen a dramatic up-tick in investor interest in select real estate opportunities. Besides the obvious core-market bias, we are currently working with multiple investors to support construction projects (multifamily and age-restricted rental) and hotel recapitalizations in core-plus/secondary markets. This activity has been a warm welcome from the 2010 doldrums and we believe it is a leading indicator of 2012 activity.

2012: more of the same, but better…

Increased NPL/Under-Performing Loan Sales & Securitizations – Banks are finally disposing of poor performing assets at an increasing rate. Loan sales teams are sharpening their marketing processes and the rating agencies have updated their NPL securitization criteria from the 1990's. The bulge bracket private equity firms will likely act as the clearinghouses for the larger pools, ultimately securitizing big chunks of poorly performing loans and selling less-liquid non-performing loans to regional sharpshooters. Cadence believes return expectations will breech 20% however, the smaller loans will be exposed to uncertain workout/recovery costs, resulting in an extremely wide-range of actual return outcomes.

Increased Recapitalizations – Middle-market private equity funds have been quite busy filling the gap between maturing debt levels and current lending parameters. This capital generally comes in as preferred equity, subordinating the borrower's position, but allowing for continuity of operations. We expect to see a growing number of operators being pushed aside, as the market increasingly differentiates between "good" operators and "average" operators. Cadence believes the market will continue to see more transactions being executed with preferred returns in the 9-11% range and total return expectations of approximately 18% (subject to a wide range of waterfall structures).

Continued Liquidity for Public REITs and Core Investments - Liquidity and transparency continue to color the decision-making process for a large portion of investors. The relatively high dividend yield of REIT equities and enviable liquidity of both their balance sheets and stock trading volumes will continue to make REITs relatively attractive. Cadence believes REITs will continue to outperform the broader market in 2012.

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