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Let the Games Begin

Investors and Fund Managers Shift Focus to High-Yield Opportunities

by Tyson Freeman

Given the severity of the global financial market collapse in 2008 and the subsequent economic fall-out, one might have expected an opportunistic property-buying free-for-all in recent years. It didn't happen. But recently limited partner investors have shown signs of shifting their intense focus on core strategies to higher risk, higher return strategies, and general partners say there are ample investment opportunities as U.S. banks begin to address their bad loan portfolios.

Today's investment environment represents a shifting landscape. U.S. banks are dealing with more of their bad loans, so there are opportunities; a similar reckoning is likely in Europe's near- to mid-term future. But industry watchers say opportunistic-style investors might run into headwinds again if limited partners retreat to more risk-averse approaches and if financial markets — the euro zone in particular — grow more volatile.

For now, general partners claim there are ample opportunities to execute solid opportunistic deals as banks and distressed lenders seek ways to restructure broken deals.

"Brookfield is looking for great assets and great companies that continue to struggle from the economic environment and how they were capitalized," says Barry Blattman, senior managing director at Brookfield Asset

Management. "There are a number of situations that have been percolating for a period of time, and now we are at the point where we can act on them."

Some market participants believe that core properties, especially those in the nation's top-tier markets, are now overpriced as a result of increased demand by risk-averse, yield-hungry investors, both domestic and foreign. More investors are now focusing on investments that can take advantage of property-level, portfolio-level or entity-level financial or operating issues.

During the past 12 months, opportunistic-style real estate fund managers have announced closings with aggregate equity capital of more than \$20 billion, according to *Institutional Real Estate FundTracker*. Among the sponsors closing billion-dollar-plus funds were well-known opportunistic players such as The Blackstone Group, The Carlyle Group and Lone Star Funds. Starwood Capital Group launched fund-raising efforts for its ninth global real estate fund in mid-2011, targeting \$2 billion to \$3 billion of equity, and Brookfield has a potential \$3.5 billion fund in the works. In addition, Blackstone has been securing a number of commitments from LPs in recent months as it markets its Blackstone Real Estate Partners VII vehicle, which could raise in the neighborhood of \$10 billion.

THE THAW

Some, but certainly not all, general partners were not as active as one might expect directly following the financial crisis, as their access to debt was limited and limited partners demanded safety. In addition, some opportunistic managers were sitting on sizable amounts of uninvested capital.

“We took most of 2009 to sit quietly while identifying and monitoring those catalysts that would force transactions to come to the market,” says Joanne Douvas, a managing director and founding principal of Clerestory Capital Partners, a fund of funds manager. “There was really not enough happening, especially for U.S. blind pool funds.” But Douvas says that activity began to percolate when Corus Bank failed and investors, most notably Starwood Capital Group, converged on commercial real estate loans in the bank’s \$4.5 billion portfolio in late 2009.

Eric Mogentale, managing principal at Walton Street Capital, notes that his firm’s collective experience in the 1980s and 1990s — when there were some tough lessons learned — allowed Walton Street to patiently restructure existing investments and actively make new investments during the past two years while others remained on the sidelines. “Our experience, or scars really, allowed us to not panic during the downturn,” he says. “On the deal side, we recognized the opportunity and were able

to aggressively make new investments, while others in hindsight missed an opportunity at a low point in the cycle.”

But, for the most part, LPs post-crisis have been licking wounds and allocating capital to less risky core and core-plus strategies. To the extent the opportunistic market was lagging, interest in moving up the risk spectrum and interest in opportunistic strategies has increased recently, and there is, for now at least, a relatively uncrowded market for deals.

“There is a bunch of competition for conventional deals that meet a stricter set of requirements, whether it is debt or equity,” says Spencer Garfield, managing director at Hudson Realty Capital. “But for those situations that don’t necessarily have all the boxes checked, there are plenty of deals to be had.”

IF THE PRICE IS RIGHT

Douvas and her partner Tommy Brown, who also holds the titles of managing director and founding principal, like to break down their analysis of the global real estate market into three general categories: slow, stuck and growth. Brown explains that the traditional bid-ask market where properties with clean capital structures are tradable constitute the “slow” category. “Growth” refers to the emerging markets where the opportunity is the creation of new real estate

stock. “Stuck” refers to the majority of the market and is essentially a structured recap — the universe of assets that have broken financial structures and require structured recapitalization.

“The most interesting thing right now is that stuck part of the market,” states Douvas. “As we see it, the opportunities right now come from recapitalizing distressed loans and acquiring loans and loan portfolios.”

The slow part of the market, the functioning marketplace made up of core-plus and value-added assets in most of the major markets, are back to their peak, pre-Lehman yields, if not prices, notes Douvas. Growth in this segment of the market is still not as compelling on a risk-reward basis as distress in the mature markets, according to the Clerestory principals.

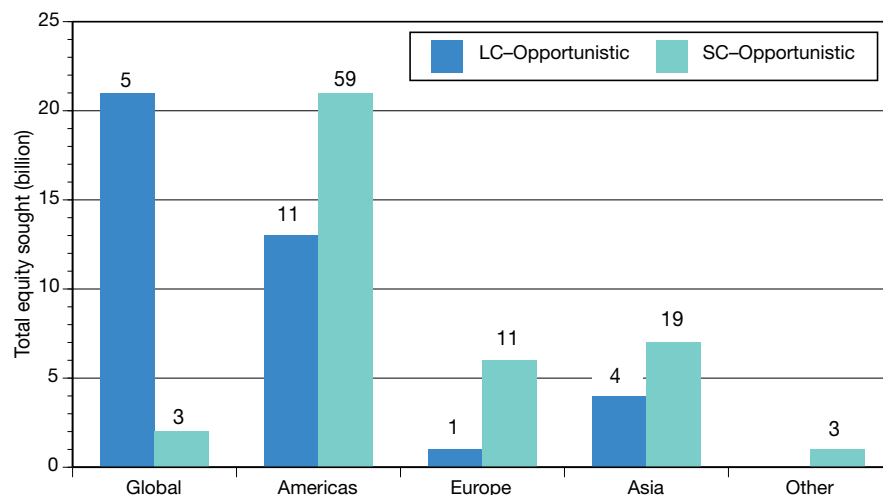
“Top-tier cities in the U.S. and Europe continue to see strong pricing for trophy properties, whereas pricing in next-tier cities is significantly off pre-Lehman values, in some cases down by 45 percent,” says Brown.

Investors are showing a clear preference for assets located in the United States. According to Clerestory research, as of midyear 2011, 70 of the 116 opportunistic funds currently raising capital are focused on the Americas (primarily North America) as opposed to other regions of the world (see “Opportunistic Funds in the Market by Geography,” left). Note that Clerestory segments the opportunistic fund universe into small cap funds and large cap funds, which are funds seeking to raise less than \$1 billion or greater than \$1 billion, respectively.

But aside from the market’s affinity for North America, Douvas is wary of getting too tied up in talking about one property market over another. “We are not talking as much about supply-demand dynamics, or certain property types at this stage,” Douvas says. “We are talking about the restructuring of broken capital stacks and being able to acquire real estate assets at deep, deep discounts to intrinsic value.”

Mogentale says Walton Street Capital is also focusing on broken deals. “By ‘broken’ we are referring to a point-in-time destabilization of

Opportunistic Funds in the Market by Geography



Data as of June 30, 2011. Foreign exchange rates as of August 29, 2011.
Source: Clerestory Capital Partners

a property, typically reflected by depressed cash flow due to market vacancy, building vacancy, ownership issues, flawed capital structures, borrower/lender imbalances, prohibitive leasing costs from steep market concessions and commissions, etc. But we have also seen and acted upon the more traditional opportunities stemming from deferred maintenance, poor building design, visibility and/or accessibility issues, operating inefficiencies, poor market perception of the asset or landlord, all of which can be correctable over time.”

Regardless of the particular property issue(s), Mogentale notes that the key is to acquire these stressed or distressed, but fundamentally sound, assets at a basis — both going-in basis and basis upon lease-up and stabilization — that represents a meaningful discount to the replacement cost and market value for stabilized institutional-quality assets. Most of Walton Street’s investments are located in major markets and take the form of buying distressed debt, deed-in-lieu or REO situations, as well as stepping into recapitalizations and other complex situations.

Bob Perry, senior managing director at CarVal Investors, cautions that this is not your ordinary cycle. “We believe that the 2008 financial crisis was not your standard crisis and this is not a standard recovery, so you have to invest differently,” he says. “At this stage, even after most asset values have dropped significantly and with the market crisis abating somewhat, we are not simply going to net long the market. That approach presumes a pro-cyclical recovery. Many are taking that for granted, but based on our insights from our credit and loan businesses, we think this will be a different recovery that demands a different response. A more measured and tactical response.”

Perry says that despite sharply lower values in many cases, it is still relatively hard to find situations where they are comfortable taking on a lot of risk. They are opportunistic-minded, he says, but they also have sought situations where they take value-added lease-up risk in markets that have a fundamentally strong demand growth profile. But Perry acknowledges the universe

of well-priced opportunities is a small subset in the United States.

“We have seen a number of situations where there is a need for rescue capital, whether it is debt or equity,” says Perry. “So we are looking at, and have acquired, distressed notes or securities — orphaned assets that have fallen off of the corporate balance sheets.”

Perry notes that they often find opportunities through proprietary channels or through their credit and loan businesses. Whatever the asset, Perry says that unlike the early 1990s, deals cannot rely on a relentless quarter-by-quarter economic rebound. Instead they are looking at specific asset and submarket dynamics that can drive fundamentals, with an emphasis on acquiring assets at intrinsically appealing, historically attractive prices.

Peter Fish, director of real estate for Fortress Group, an Atlanta-based fund placement agent, says he sees an opportunity for funds originating new loans. “There is appetite for loans on non-life insurance type assets,” he says. “Lenders can charge pretty decent rates and also pull in some fees. They can get good pricing and good risk-adjusted returns for senior and mezzanine debt, especially if they use balance sheet leverage. So LPs investing in real estate funds are asking themselves, ‘Would I rather be an equity owner and take down a 15 percent return, or be at 65–70 percent loan to value in the first mortgage position and get a 10 percent or 12 percent return?’”

Garfield of Hudson Realty Capital says that his firm has been active in the past year, and some of it has been in new originations of bridge loans and senior debt. He says they booked \$120 million in new loans and around \$400 million in loan acquisitions.

Garfield says the firm’s emphasis has been on multifamily assets with a fair amount allocated to retail. “We feel we are on more solid ground fundamentally with multifamily,” he explains. “They are easier assets to understand and underwrite. And you are working with one-year leases, so any stress they’ve encountered runs right through the leases as opposed to something like a suburban office deal where the leases were written five year ago. It is more difficult to

see where the market levels out in that situation.”

But, Garfield adds, Hudson Realty is open to the right hospitality or office asset. Geographically, the focus has been on more stable markets in the Northeast, but they also have invested a fair amount in Texas. “Overall, we are more focused on individual deal situations right now than in any one region,” he says.

With regard to loan acquisitions, there are basically two approaches in this environment: lever up less risky assets, or use modest or no leverage and pursue assets in secondary markets. Hudson Realty takes the latter approach.

“We are focused on smaller value-added type deals in the \$5 million to \$35 million range in class B markets or in the surrounding areas of class A markets,” says Garfield. “Where we are not willing to take a risk is with leverage.”

Brookfield Asset Management is active on many fronts, most notably in taking down large deals. Brookfield now owns a 40 percent stake in retail giant General Growth Properties, most of which was acquired when the company’s stock was at its nadir. And recently the firm announced plans to buy Stuyvesant Town and Peter Cooper Village in New York City from the special servicer that controls the massive residential complex. But, in addition, the firm has been an active player in office, hospitality, industrial and retail as well, says Blattman.

“We try to focus on the very large deals and make sure the right capital structures are in place, ones that can withstand what continues to be a challenging economic backdrop,” explains Blattman.

INTERNATIONAL FRONT

It was clear that the firms interviewed were mostly focused on finding broken deals at deep discount in the United States. But opportunistic investing during the past decade has centered largely on emerging markets. So where do the investment opportunities in emerging markets, or beleaguered Europe for that matter, fit into the picture?

Clerestory breaks down emerging markets into three groups: emerged, emerging and frontier.

Brazil, India and China, whose economies and financial systems are well developed, are considered “emerged.”

“Providing new real estate stock is the major theme in emerging countries for the foreseeable future,” says Brown. “So our focus in those regions would be on select development and structured products in development projects.”

But with the current opportunities available in the United States and Europe, Douvas believes now is not the time to focus on emerging markets. “Returns in emerging markets are not all that different than here in the States,” she says. “And with those types of projects you are accepting development risk on top of the typical emerging market risk. We think it is best to be investing in the mature markets. A lot of these deep discount deals produce very good returns with little or no leverage.”

Which brings us to Europe. Despite pockets of opportunity, most investors are taking a more patient approach to Europe. Continued volatility in the capital markets, along with economic uncertainty is expected to further accelerate the transition of broken capital structures back to the marketplace. So better entry points will likely emerge.

“Europe is lagging the U.S. by almost two years in terms of their banks’ willingness to address their situations,” Douvas says. “So it is early for Europe, but it is going to get interesting.”

Perry of CarVal Investors also sees future promise in the euro zone. “The need to delever and raise capital on behalf of European banks is there,” he says. “They are going to be selling all sorts of assets up and down the credit structure, and we are poised to look at securities, debt, equity, all sorts of distressed positions.”

Blattman states that Brookfield is already finding plenty of deals in Europe and the United Kingdom, and has recently closed transactions in Australia. But he suggests that the real opportunity for Europe is still ahead. “We are watching the situation in the United Kingdom and Europe carefully,” he says. “We want



Big Deal: Toronto-based Brookfield Asset Management announced plans to team up with tenants of New York City’s Stuyvesant Town and Peter Cooper Village to buy the troubled rent-regulated complex from creditors and turn it into affordable condos.

to make sure that we are able to participate in those areas on a large scale if there is disruption there.”

FUTURE FOCUS

There is more capital beginning to flow to opportunistic strategies, and there are deals to be had, but the road to higher risk returns might get bumpy. One managing director of an opportunistic fund that wished to remain anonymous says that he has seen the market retreat some in the past six months, mostly due to the uncertainties surrounding Europe.

Garfield says that he expects things to be similar to the end of 2010 or early 2011. That is, more capital will flow to opportunistic strategies and assets, and that will create some pricing “confusion” in the market.

“You have some CDO managers who now have capacity, and they are trying to build pools with cash-flowing assets,” observes Garfield. “You will start to see that affect pricing up the chain. You can have a small deal in a secondary or tertiary market and that will all of a sudden attract low-cost debt. Some will say that is crazy, but different players have different motivations.”

Fish also believes the market is

starting to get challenging again. “It started to look like momentum was building in 2010 and 2011, but by August of 2011, it started to go the other way a bit,” says Fish. “Investors are still very interested in cash flow. Generally, the market is really not being paid sufficiently to take a lot of additional risk.”

Fish adds that there are always exceptions. If a fund has a knack for sourcing distressed deals, has a lot of cash ready to move quickly, and the capacity to conduct due diligence, opportunities will remain. But he says there is a finite set of opportunistic funds that can do that.

So opportunities for higher yielding investments currently exist and may soon expand, but no one expects “sure things” and “easy money.” Due diligence and risk management will be more important than ever. ♦

Tyson Freeman is a freelance writer based in Sebastopol, Calif.

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