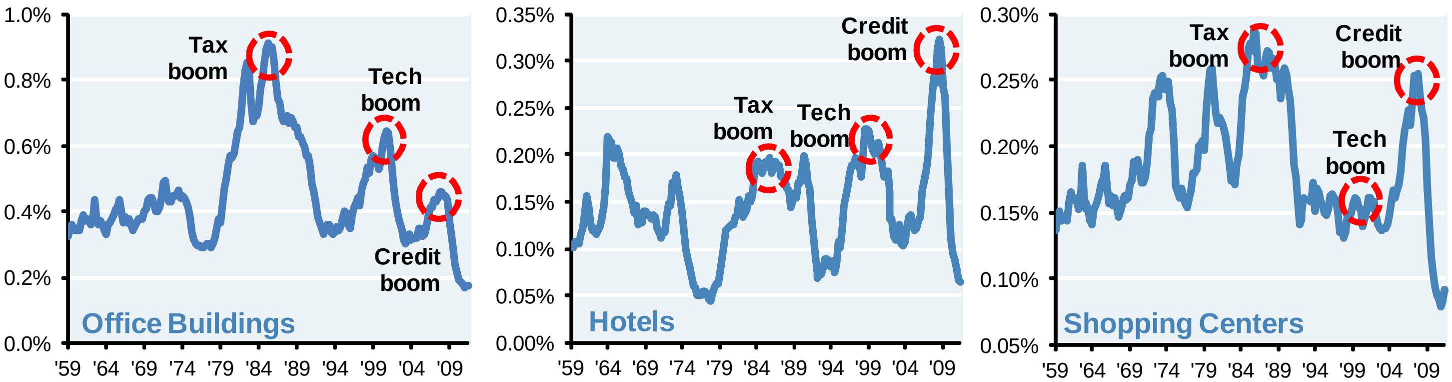
Opportunity knocks: the risks and rewards of opportunistic real estate investing

The ever-expanding ECB balance sheet (next repo operation of $1 trillion?), Chinese liquidity injections and commitments by the Fed to provide free money forever have given markets a reprieve of unknown duration. This allows us to focus for a moment on investments in commercial real estate[1]. In the US, supply and demand factors are, *on the margin*, improving. On demand: declining vacancies and improved data on manufacturing, small business optimism, bank lending to businesses and some housing indicators. It's not *that* good, of course, since if it were, the Fed would not be keeping the cost of money at zero (Q4 GDP was a bit of a letdown, given the large contribution from inventory build). This is still a weak recovery by almost every measure with the exception of corporate profits. On supply: as shown below, the recession brought about a collapse in new construction of office, hotel and retail space, a necessary precursor to eventual rental growth and declining vacancy. What is notable: office markets expanded less during the credit boom than either hotel or shopping center space, in relative terms.

Third boom-bust brings construction to an all-time low
Private fixed investment by category, % GDP

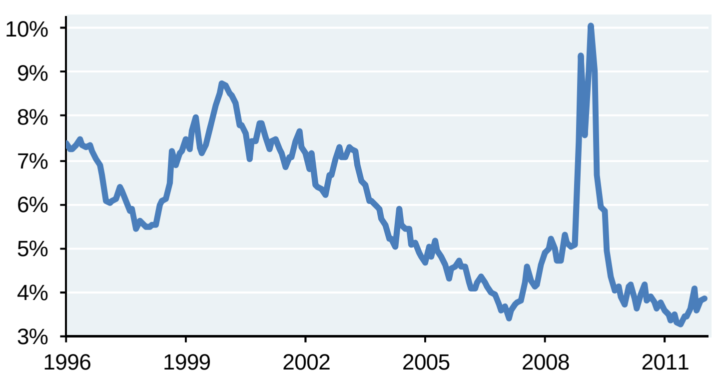


Source: Bureau of Economic Analysis. See Appendix for definition of "Tax Boom."

Reit-er Madness

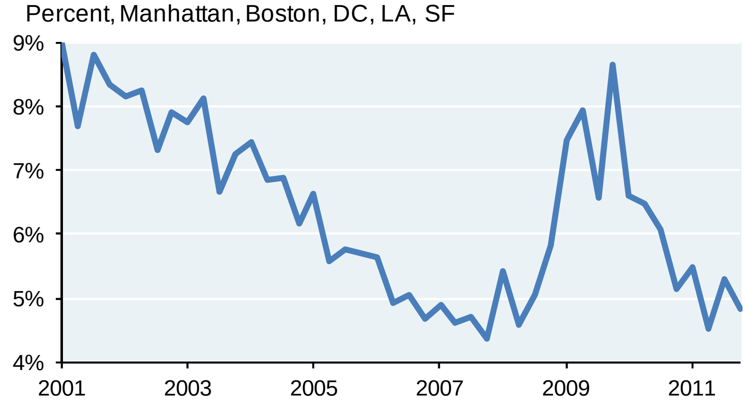
The Fed's zero interest rate policy has created (another) cycle in which yield-hungry investors drive up prices of traditional commercial property investments. Two examples: the decline in REIT yields, and the declining "cap rate" (running yield) on well-leased central business district office properties. This is consistent with what we saw last year in the US equity markets: utilities had the worst earnings growth, but was the highest performing of the ten S&P 500 sectors given its high dividend yields. Conversely, the highest earnings *growth* sectors (industrials and materials) had among the worst stock price returns. Empirical Research Partners took a closer look at the market's dividend obsession: in 2011, dividend yield was by far the dominant factor in stock-picking, and was much more closely tied to stock price performance than factors such as earnings growth or return on equity. **Bottom line: for investors, realizable cash flow is king.**

Real Estate Investment Trust dividend yields
Percent



Source: NAREIT, Bloomberg.

Central business district office cap rates
Percent, Manhattan, Boston, DC, LA, SF



Source: Real Capital Analytics.

We could recompute these charts in "spread" terms, by looking at them net of the 10 year US Treasury; they would look cheaper that way. However, this is not your father's Treasury market. Non-economic buyers (Fed, non-US Central Banks) own more than half of all Treasuries, and it is not clear what the Treasury yield would be if based only on private demand.

[1] Last summer, we wrote a piece on the "*Rise and Fall and Rise of Commercial Real Estate*" (July 5, 2011), which focused on the mistakes made during the prior cycle and the factors which led to the collapse. This piece looks forward at opportunities that exist today.

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Alternatively, we could rescale the charts in "real" terms, net of inflation. However, the current 2.5%-3.0% headline inflation range is not that different from what prevailed over the last 15 years (with the exception of the collapse in 2009). The better news on valuation is that REIT dividend payout ratios of 70% are below their long-term 82% average, implying dividend increases in the future. **All things considered, traditional high quality commercial property is pretty well bid by investors looking for a stable return.** One example: the 4.5% cap rate paid by a REIT for the Market Square complex in DC last year. At $905 per square foot, it was the highest trade on a per square foot basis in Washington, DC history.

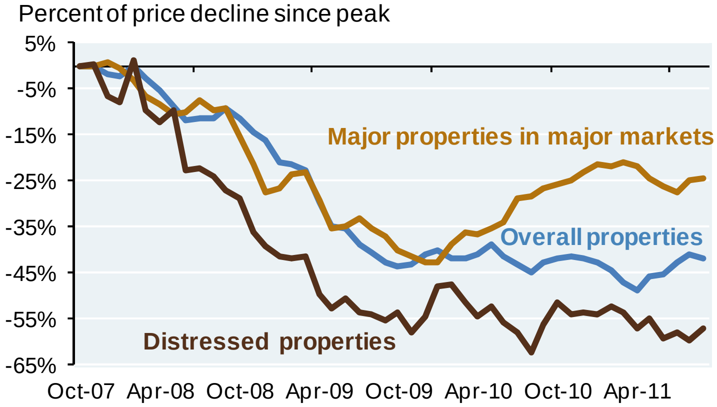
Opportunistic real estate investing

"Opportunisitc" investing is a complement to traditional investing, and may benefit from the widening gap between the price of core and distressed real estate. Opportunistic properties are typically available at substantial discounts, for a variety of reasons:

- *Off market locations* (e.g., 9th Avenue vs. 7th Avenue in NYC; Isle of Dogs vs. City Center in London; our south-of-Market Street building in San Francisco, particularly when we moved there in 2001; or suburban locations just about anywhere)
- Substantial amount of *unleased space*
- *Owner capital problems* (overstretched, unable to fund tenant improvements and leasing commissions; over-leveraged and funneling cash away from good properties to save struggling ones)
- *Debt problems* (debt service coverage close to breaching actual or technical default, and/or pending debt maturity with loan to value well above 100%). Adding to the pressure for over-leveraged borrowers: CMBS markets face a total of $135 billion in maturities from 2012-2014 (as per S&P), while new CMBS issuance was only $30 billion in 2011
- *Banks* with no interest in maintaining or improving foreclosed property. Basel rules require much higher capital charges for foreclosed real estate (compared to performing loans), and Tier 1 capital ratios are still rising; both explain why banks often opt to sell foreclosed commercial properties quickly
- *Unfinished spec properties* that need a last round of fresh capital to be completed

The widening gap between core & distressed real estate

Percent of price decline since peak



Source: Moody's Commercial Property Price Indices.

The risks and rewards are of course higher than for traditional "core" property. To give you a sense for what opportunistic real estate investing entails, I talked to some of our managers and chose three illustrative examples. **There's a common theme: over-leveraged owners that allowed their properties to suffer competitively.** Slower growth and pending maturities have exhausted cash reserves, putting into higher relief the extent of over-bidding during the credit boom. To participate in this space, managers must be well-funded, with the ability to move quickly regarding property underwriting and financing.

Example #1: Selling the family jewels

During the prior decade, a non-US owner of retail centers conducted a roll-up strategy in the US. The strategy involved the acquisition of several hundred US neighborhood and community shopping centers. The recession hit, and the owner was forced to raise capital quickly to resolve leverage issues at the parent company back home. The US assets were the most logical place to look for liquidity. The opportunistic buyer benefited from two factors here:

1. **The seller needed a lot of money, quickly**. The purchase price was several billion dollars, an amount that narrowed the field of potential acquirers.
2. **The prior owner's capital structure was a mess**. The retail centers were not wholly owned, but held in a complex maze of joint ventures with different partners. As a result, when the recession hit, the owner did not have the ability to pool cash flow to fund tenant improvements needed to retain existing tenants and attract new ones. The reason: there was no economic incentive for the joint venture partners to permit this.

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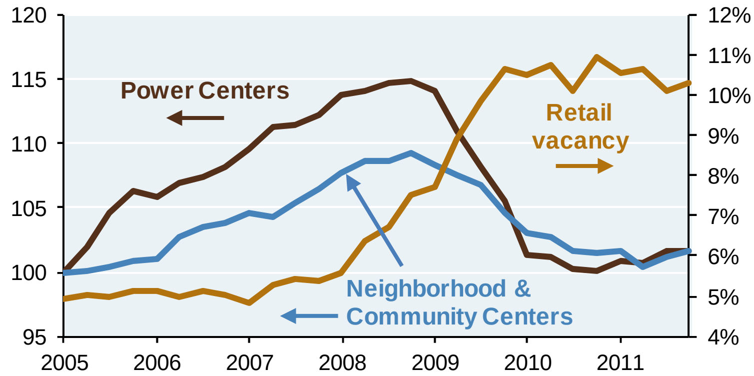
A well-capitalized buyer closed on the transaction quickly, and set to work on increasing occupancy. The numbers: the buyer's cap rate was 8%+ on current occupancy of 87%, with an acquisition price of ~$100 psf (estimated at 40% below replacement cost). Public retail center REITs generally trade at around a 6.5% cap rate on 92% occupancy; this spread between private market and public market pricing is one of the factors that make private investments in real estate interesting right now. Most of the property-level debt remained in place, at an average cost of ~6%.

The key issue is whether retail has stabilized. Nationally aggregated data from NCREIF suggest it has. As shown, national vacancy rates appear to have peaked, and net operating incomes are finally, slowly, starting to rise again.

Retail commercial property finally hits bottom



Source: NCREIF.

At the property level, the buyers are also seeing improved net operating income and leasing activity: total leasing volume on their retail centers in 2011 rose by 20% vs 2010. Releasing spreads (the degree to which rents rise when leases mature) hit 4.6% in 2011, compared to flat y/y results in 2010. The buyers expect same-space NOI growth of around 1.8% per year, of which 70% can be attributed to contractual increases in rental payments on existing leases (i.e., assumed releasing spread of 0.5%).

A comment on tenant improvements. A common benefit for opportunistic buyers: being able to increase leasing activity, simply by funding tenant improvements for new and existing tenants that prior owners could not. In *theory*, a prospective tenant would be indifferent to tenant improvements paid for by the property owner, or a longer period of free rent (in which case the tenant pays for the improvements themselves). But in a world of constrained capital, particularly for high-volume, low-margin retailers, the indifference curve is not so simple. By some estimates, expanding retailers would have to expand half as quickly if they had to fund their own space improvements. That's what puts well-capitalized new property owners in a good position to ramp up leasing at neglected properties. In this case, the owner identified profitable lease opportunities that required $300 million in liquidity to execute; the owner estimates a 15% return on these capital commitments.

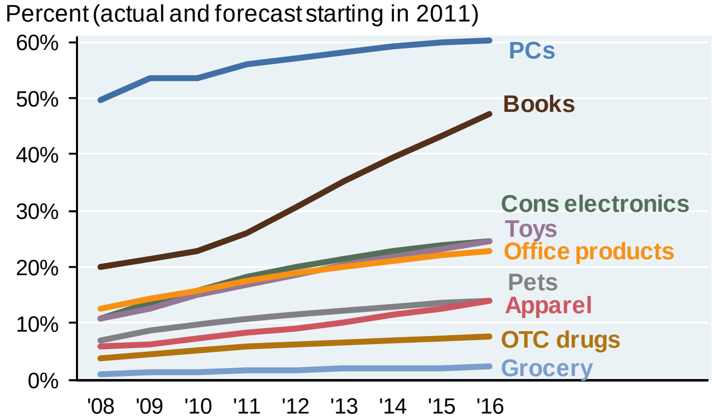
What could go wrong? It was only a few months ago when the ECRI was predicting an unavoidable recession in 2012. We disagreed at the time, and still do. However, the US is far from a self-sustained recovery, and growth may weaken a bit more in 2012, depending on the outcome of negotiations on payroll tax cuts and unemployment insurance extensions. Disposable income growth is also pretty weak, particularly once you strip out government transfers. The risk: labor incomes don't improve, consumers stop drawing down on savings to finance consumption, and consumer spending weakens in 2012, after improving during the second half of 2011 (2011 Q1 – Q4 annualized real consumption growth: 2.1%, 0.7%, 1.7%, 2.0%).

The other big risk is **structural change (the internet)**. After all, we had to make adjustments to December payrolls to reflect temporary hiring of couriers delivering goods ordered via internet. Some tenants in these centers (Best Buy, Staples, Bed Bath & Beyond) are in the bull's-eye of the internet buying phenomena. The risk: such tenants lose ground to online competitors, and/or become less space-intensive due to their own rising internet sales. **On the other hand, the centers' largest anchors by far** are grocery chains (Kroger, Ahold and Safeway), heavily discounted apparel (TJ Maxx), and other large discounters (Walmart, Kmart, Kohls, Dollar Tree and Big Lots). As shown, these categories exhibit considerably less sensitivity to internet cannibalization on volume and pricing.

Let's assume that instead of reaching pre-occupancy levels of 92% over 5 years, internet competition and subpar growth cap occupancy levels at 90%. Furthermore, let's assume that the only lease increases are contractual, with releasing spreads of 0% at lease maturity. A rough estimate of the project's internal rate of return would decline by around 5%. As a general rule, the more national the footprint of a retailing investment, the more it's a wager on whether the US sinks back into recession. So far, the news is good, but there's a long way to go.

Online sales as a percent of total category sales

Percent (actual and forecast starting in 2011)



Source: Forrester Research, Inc.

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Example #2: Hotel California

The Eagles had it wrong: you can check out any time you like, but you might have to leave your deed to the property on the way out. Some background: there's a landmark hotel with over 1,000 feet of beachfront in an iconic location in California, with several hundred rooms. The prior owners leveraged the property at 84%, which is high for a hotel, given its cyclical revenue patterns. During the recession, the hotel's NOI plummeted, and the loan-to-revised value rose over 100%. With a maturity looming for the prior owners, they had to decide whether to recapitalize the property (in order to refinace it) or walk away.

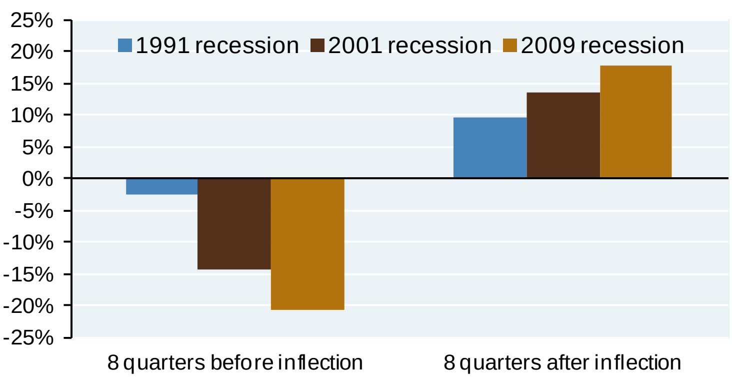
While they were debating the issue, the loan on the property was approaching maturity, and one of the mezzanine lenders wanted to sell their position. The lender was a CDO, which is a passive vehicle that generally follows a specific set of rules when things go wrong. The CDO wanted to sell, and to the highest bidder as quickly as possible. A bidder acquired the mezzanine position at a very small premium to what the property's owners were willing to pay for it, which led to the new bidder acquiring a control position and executing a restructuring. **Using a mezzanine position to obtain ownership is a common practice:** mezzanine lenders are often not in a position to see a property through bankruptcy/restructuring, have no capital to contribute to the property, and are often anxious to put a problem investment behind them.

Some numbers: the opportunistic buyer ended up acquiring ownership of the hotel at a 20% discount to its 2005 purchase price, and using a capital structure with less leverage (70% LTV on a revised lower valuation). The lower purchase price gives the buyer a fair bit of breathing space should economic conditions weaken again: **NOI could decline by 35% before the interest coverage on the new debt would fall to 1.0x.**

As with the shopping center investments, the key issue here is whether hotel occupancy rates and room revenues are on the upswing. The cyclicality of hotels is legendary: as shown below in the first chart, NOI declines are quite sharp when recessions hit, but they often snap back when recessions end. One reason for this: fixed expenses are high (50%-60% of total expenses), which creates a lot of operating leverage. That's either good or bad, depending on the part of the cycle you're in. Good quality hotels have *some* flexibility on cutting staffing, capital expenditures and sales & marketing during a recession, but there are limits. One rule of thumb: NOI declines twice as much as revenues when the economy slows down.

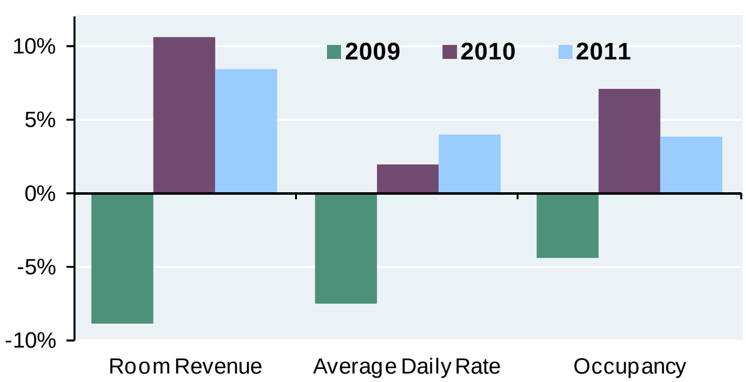
There is evidence that on a national level, room revenues (a rough product of average daily room rates and occupancy levels) are improving, as shown in the second chart. **As for the hotel property in question, RevPAR (a measure of revenues per available room) was up 8.5% in 2011 after rising 5.9% in 2010**. The buyer expects revenue growth to average around 5.5% for the next five years, a function of both improving occupancy levels and rising room rates.

US hotel performance during recent recessions
Average annual change in NOI



Source: Smith Travel Research, PKF Hospitality Research.

US hotel industry performance
Percent change, YoY



Source: STR Global.

What could go wrong here? The property had been well-maintained by its prior owners, so unexpected capex does not appear to be the big issue. They are also assuming to sell the property at roughly the same multiple they bought it at. The risk appears to be a slower than expected recovery in revenues: at 3% revenue growth instead of 6%, the buyer's return would fall in half as well. **The buyer base is also a potentially limiting factor**. Even at a 20% discount to its 2005 purchase price, the hotel was priced at $800k per room; that's a pretty high number. For the sake of comparison, here are some other 2011 hotel acquisitions with high prices paid per room: Los Angeles Mondrian ($578k), San Francisco Huntington ($535k), the New York City Royalton ($525k) and the Rhode Island Ocean House ($747k). Significant non-room revenues make these comparisons imperfect: these other hotels do not have a 65,000 square foot convention center, nor do they benefit from revenues related to leasing on-site condominium properties. Even so, the new owner will need to succeed in growing revenues and in finding a buyer for a unique premium-priced hotel; otherwise they could be stuck in a Hotel California of their own.

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Example #3: Adventures in suburbia

When you mention suburban office space and recessions, even experienced real estate people usually become a little faint. Fewer constraints on new construction and rising vacancies due to localized small business failures can make for a rough ride for investors. The last example deals with an office building in the suburban location of West Cambridge, Massachusetts.

OK, West Cambridge is not exactly *suburban*, but it is definitely not urban; it falls into an in-between category. With a few hundred thousand square feet of office space spread across two buildings, the site is one of the largest properties in the area. It is also the **Bobo Newsom**[2] of suburban office, having been sold and resold several times over the last decade. The most recent owner (a brokerage firm's institutional investment arm) bought the property in 2007 when it was 78% leased, and leveraged it at 78% loan to value. The recession hit, the owner either ran out of capital to retain tenants (or opted not to deploy it), and occupancy fell to 48%. You could have heard a pin drop on half the floors by the time a UK bank foreclosed on the property.

The risks are substantial, but in opportunistic real estate investing, every risk has a price. A new buyer stepped in and bought the property from the bank. The new owner, with several million sq ft of office space in the Boston area, had a game plan:

1. They looked to East Cambridge, which is 92% leased (lot's of proximate biotech and MIT-related demand) and where rents are twice as high. West Cambridge does not have the same cachet, but it has *some* potential to **draw existing tenants away from East Cambridge**, and attract new tenants in the area put off by the higher East Cambridge rents. So they bought the property at $178 psf, an estimated 46% discount to replacement cost.
2. They started **investing in tenant improvements**, the first time in a couple of years that the property benefited from properly capitalized ownership. Instead of showing raw space with exposed fireproofing and uneven walls, show completed turnkey space. The new owners have already signed leases that put the property's debt service coverage above 1.0x. One benefit of owning a lot of space in the area: the ability to subcontract tenant improvements at the lowest possible cost.
3. Our commercial tenant clients will probably raise eyebrows at this one, but there are some things that property owners can do to "**increase rentable square footage**". One example: invest and reduce the size of HVAC systems, and recover rentable space. Property owners can also have the space re-measured according to existing regulations. In doing so, the new owners increased rentable square footage by 7% (it's like the shrinking candy bar phenomenon: pay more for less).
4. **Explore options for an undervalued, attached piece of land** given the strength of the multifamily rental market. An associated land parcel valued at $10 psf is now in contract for $74 psf.

So, with a plan to attract new tenants at low rents, the owners aim to resuscitate the property for an eventual sale to a traditional core buyer. They have a long way to go: their assumed occupancy rate at exit is 94%, which would generate a 9.5% running cash yield and a healthy double digit return on their equity investment. It's pretty clear here what could go wrong: the status quo does not change much, leasing activity is slow and the property has to be sold to another distressed buyer. As an option on management's ability to rescue a suburban property in distress, it appears properly priced.

Michael Cembalest
Chief Investment Officer

An explanation of the "Tax Boom", shown in the first three charts. The 1981 Economic Tax Recovery Act ushered in accelerated depreciation allowances for real estate and the ability to offset active income with passive losses. This fueled a massive expansion in commercial property construction. The 1986 Tax Reform Act ended this tax arbitrage. Unoccupied buildings never needed in the first place drove vacancies to 30%-40% in some cities, prices collapsed, and banks suffered losses of 15% or more on commercial property loans. As for the tech boom, markets were pricing in 5% perpetual GDP growth and the elevated payroll growth/office space needs it implies. The tech sector played a large role (as one sign of optimism, Cisco traded at 150 times earnings), but it wasn't just tech that was expected to expand; Merck traded at 35 times earnings. As a sign of how things have changed, both Cisco and Merck now trade closer to 10 times earnings.

"***Opportunity, please knock***", from the album *Free Spirits*, Chris Connor, Atlantic Records, 1962

ECB - European Central Bank; REIT - Real Estate Investment Trust; NCREIF - National Council of Real Estate Investment Fiduciaries; PSF - Per Square Foot; NOI - Net Operating Income; CDO - Collateralized Debt Obligation; LTV - Loan to Value; CMBS - Commercial Mortgage Backed Securities; ECRI - Economic Cycle Research Institute

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[2] According to The Baseball Almanac, **pitcher Bobo Newsom** was traded 14 times between 1929 and 1947 (the most ever). Another metaphor could be the Jasper Johns painting "*False Start*", which was sold by taxi magnate Robert Scull to architect Francois De Menil, then to publisher Si Newhouse, then to media entrepreneur David Geffen and then most recently to hedge fund principal Ken Griffin. But for a suburban office property in West Cambridge, the Bobo Newsom comparison (and his 211-222 lifetime won-loss record) is more apt.

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