

Opportunity Funds OVERFLOWETH

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Fresh off a real estate cycle in which private equity funds poured hundreds of billions of dollars into commercial properties and pumped up prices, the unabated credit imbroglio and a souring economy are chipping away at commercial real estate's once-heady appreciation. Real estate opportunity funds are now raising tens of billions of dollars to pounce on properties and mortgages as values head back down.

Yet the billion-dollar question is whether all of the anticipated distress will occur. The dearth of transactions currently provides no indication. Daniel Clemente, CEO of Vienna, Va.-based Clemente Development Co., is wagering that property values will begin plummeting early next year.

That's when commercial real estate loans with lax underwriting will start coming due, he says, and landlords will face defaults because they'll be unable to refinance the heavy doses of debt they put on the properties. He sees the shakeout lasting through 2012.

"Even though buyers overpaid for properties, loans aren't in default yet because today's net operating income still covers a 5% interest-only mortgage," says Clemente, whose firm has launched a \$1 billion vulture fund to acquire distressed properties. "But you're going to have a problem because the originators were making money on originating loans, not on collecting payments on the loans."

Capital raising bonanza

Clemente's hardly alone. According to Private Equity Intelligence Ltd., a London-based organization that tracks real estate private equity funds, 144 U.S.-based opportunity and value-added funds in the market are looking for a total of \$93 billion. Of those funds, 35 had raised \$33.4 billion year-to-date as of mid-July. Last year, 85 U.S.-based opportunity and value-added funds raised nearly \$50 billion.

While the strategies behind these capital pools vary greatly, fund managers are increasingly focusing on distress. Among notable sponsors that have recently launched opportunity funds to hunt for endangered commercial real estate assets:

- Los Angeles-based CB Richard Ellis Investors has raised a \$2.1 billion fund that features two separate partnerships. One partnership is targeting distressed assets with high vacancies, among other strategies.
- New York-based Morgan Stanley Real Estate is raising \$10 billion to finance distressed properties around the world, including debt and equity.

- Philadelphia-based Lubert-Adler Partners is raising \$2.5 billion to invest in distressed properties and debt.

Several managers have also launched their first funds — but the climate to attract capital is getting tougher (*see sidebar*). Most opportunity fund managers say they fully expect to achieve traditional returns of about 18% or higher.

Paul Dougherty, president of Washington, D.C.-based Perseus Realty Partners, is aiming for a minimum 20% internal rate of return in the second opportunity fund that his firm has launched in the last four years.

Unlike Perseus Realty's first fund, which has a hold period of about six years, the current fund is factoring in an eight-year hold. The firm has raised about half of the \$200 million in equity it's seeking and plans to invest in financially distressed properties as well as development deals and rehab opportunities.

The longer-than-expected financial dislocation and deteriorating economy, while not desirable, could ultimately enhance returns, Dougherty suggests. "If anything, we're continuing to move further away from a recovery, and I'm very concerned about that," he says. "But in our minds it presents the best environment for investing in real estate in the past 15 years."

Defying distress for now

Achieving fat returns solely through distressed plays today is proving tough. The funds typically want to leverage their equity with about 60% of debt, but the illiquid credit markets have made it increasingly difficult to secure that capital. Ironically, many would-be sellers aren't under enough pressure to unload their properties.

"Commercial real estate has held up — you're only just now beginning to see some pain in the industry," says Dennis Yeskey, national director of real estate capital markets for Deloitte & Touche. "We're not distressed, but there is some stress."

Indeed, real estate fundamentals remain relatively healthy. Office vacancies crept up 20 basis points to reach 13% in the second quarter, according to New York-based Reis, but that's still well below the vacancy rate of 16% in early 2005. Meanwhile, effective rents in the office sector are still rising, albeit at a slower pace. Effective rents rose 0.7% in the second quarter compared with 1.5% in the first quarter.

Some real estate experts don't expect to see the same deep discounts for properties that marked the turbulent early 1990s, when fundamentals didn't support speculative construction. Nonetheless, exuberant lenders financed the projects, and

the vast supply overhang fueled a downturn that resulted in depressed properties trading for pennies on the dollar.

The same amount of overbuilding hasn't occurred this decade, experts insist. With the exception of some new condominium and retail lifestyle center developments in Florida, Las Vegas, Southern California and a few other markets, the lion's share of loans were made on existing properties, says John Pelusi, CEO of Pittsburgh-based Holliday Fenoglio Fowler Inc. The commercial property mortgage intermediary's shares were trading around \$5.50 in mid-July, down roughly 64% from a year earlier as transaction volume among buyers and sellers of real estate has plummeted.

"In my 28 years in the business, I don't think supply and demand have been more in check," says Pelusi. "But are there going to be issues? Probably. The economy's getting worse, energy costs are up, food costs are up, and it's difficult to get debt."

Indeed, job losses totaling 438,000 during the first half of the year and a 5% rise in the consumer price index between June 2007 and 2008 — the largest increase since 1991 — could lead to higher vacancies and falling rents, particularly in office buildings and retail properties. That would accelerate any deterioration in property values.

Still, most landlords remain current on their debt. Delinquencies of commercial mortgage-backed securities (CMBS) stood at 0.48% in the first quarter, up slightly from the end of 2007, according to the Mortgage Bankers Association. Life insurance company portfolio delinquencies remained unchanged at 0.01% in the two quarters, while banks and thrifts reported commercial real estate mortgage delinquencies of 1% in the first quarter this year, an increase of 20 basis points over the rate at the end of 2007.

Profiting from pain

Opportunity funds concentrating on distress intend to take advantage of the seized-up debt markets in a few different ways. Many funds are buying debt at a discount from investment banks stuck with billions of dollars of loans they can't securitize.

Other investors believe loose underwriting and over-leveraged properties will soon lead to maturity defaults, essentially defaults that occur when a landlord can't refinance a property because it isn't worth the loan coming due or because a landlord can't come up with a slug of equity that lenders want. Those funds intend to buy up that real estate, or at least gain a position in the assets.

Buyers of distressed debt are benefiting from the residential subprime mortgage crisis, which spilled into the CMBS market and virtually shut it down. As a result, investment banks were forced to keep tens of billions of dollars of loans on their

balance sheets. Subsequent write-downs of the loans have weakened the financial strength of many banks.

Banks initially tried to avoid a fire sale of their loan assets by issuing billions of dollars in new equity to strengthen balance sheets. But their share prices have plummeted.

That makes issuing additional equity more difficult and puts even more pressure on the banks to sell loans, says Mark Osgood, president of a debt fund for Irvine, Calif.-based Thompson National Properties. Anthony "Tony" Thompson, former chairman of Grubb & Ellis Co., launched the real estate investment management firm about four months ago.

"While we don't like seeing so much red all over the screen, it does play into our hands," says Osgood, who declined to provide details about transactions or the fund's size. "The terms are going to be better for us."

Among larger dispositions, Lehman Brothers Holdings sold \$4.2 billion in senior and mezzanine loans and \$1 billion in equity as part of a broader \$8 billion sale in the second-quarter sale to reduce its commercial real estate exposure. Some of the assets were sold at a 35% discount to par, or "haircut," Lehman reported.

Seeking subordination

Other landlords also are hunting for mortgages on the cheap and are paying close attention to subordinated debt. Los Angeles-based Younan Properties, a private investment group that owns 12 million sq. ft. of office space in the U.S., in April launched a \$200 million fund to buy performing and distressed commercial real estate loans ranging from \$5 million to \$50 million.

So far, Younan has acquired a \$6.5 million mezzanine loan and has agreed to buy another \$22.9 million loan from Rubicon Capital America, an affiliate of Australia-based Rubicon America Trust.

Rubicon America Trust manages a 6.3 million sq. ft. portfolio of primarily office buildings and about 40 commercial real estate loans, but in late June the company announced that its properties had dropped 7% in value to \$1.2 billion. That puts the trust in danger of breaching some financial covenants.

San Francisco-based Shorenstein Properties, a real estate fund sponsor and developer of office buildings throughout the U.S., has opportunistically bought five subordinated loans and originated four others for a total of about \$650 million since last fall.

Robert Underhill, a Shorenstein managing director and head of the capital transactions group, says the discounts on the loans acquired from other lenders ranged between 5% and 20%. Among other deals, the company bought a \$35 million subordinated loan tied to the MTV Building in Santa Monica, Calif., from UBS Real Estate Securities early this year.

Funds focused on the loan-buying strategy are wagering that the credit markets will be back open for business when the notes come due over the next several months. But they're also hedging that bet by buying loans on properties that they would be happy owning.

"We typically aren't doing this as a loan-to-own; we're doing it with the objective of being paid off," Underhill says. "But we're only going into situations where high-quality real estate underpins these subordinated debt pieces, and that give us the comfort to move forward."

Subprime similarities

Real estate money managers also are sniffing out potential maturity defaults among developers with construction loans as well as landlords who must refinance existing mortgages in the coming months. Much of that activity is still to come, and investment advisors aim to either partner with developers or provide subordinated debt or preferred equity to help prevent defaults. Some, however, plan to acquire buildings outright upon a maturity default.

Clemente of Clemente Development, which is raising a vulture fund, is betting that CMBS loans made on projections of future rents rather than current rents will lead to rampant defaults. When those rents fail to materialize, property values will drop, and landlords won't be able to refinance their buildings, he says.

That's especially true given the fact that lenders are now applying much stricter underwriting standards and are only providing debt up to 55% to 60% of a property's value, instead of 75% to 80% as recently as last year.

"A lot of CMBS loans were placed just like the subprime residential loans were placed — on projections of future value," says Clemente, whose firm sold a handful of properties in the Washington, D.C., area at the top of the market for \$200 million.

Early distress signals

Some of those issues have already hit high-profile developers. New York real estate mogul Harry Macklowe financed seven Manhattan towers using \$7 billion in short-

term debt in 2007. But he later defaulted on the loans when they couldn't be refinanced and eventually handed over the keys to lender Deutsche Bank.

Private equity investment advisor Broadway Partners, based in New York, meanwhile, borrowed billions of dollars in short-term debt in 2006 and 2007 to finance acquisitions of office buildings. Much of the debt will come due early next year, and the company is pursuing a range of strategies to retire or buy down some of the debt.

In early July, Broadway Partners sold the 31-story One City Centre office tower in Houston to Dallas-based Behringer Harvard REIT I for \$131 million. Broadway Partners had paid \$115 million for the building 18 months earlier and raised occupancy to 95% from 82%.

Meanwhile, fund managers are scouring the market for other opportunities. In early July, Perseus Realty announced its new fund was making a \$4.6 million investment to develop a \$29.7 million apartment community in Atlanta that will include 306 units. Perseus Realty is partnering with Atlanta-based Hathaway Properties in the deal.

Although the project doesn't fall into the distressed category, the illiquid credit markets fueling anticipation of widespread pain also are helping opportunity funds get better terms on conventional investments.

"The tenor has changed dramatically over the last year, and it's an investor's market," says Dougherty of Perseus Realty. "We can demand better returns for our investors because risk has shifted from us back to development partners."

Joe Gose is a Kansas City-based writer.

Uncertain times give pension funds cause for pause

The anticipated distress in the commercial real estate market combined with executive departures from financial houses, home builders and mortgage lenders has spawned several first-time opportunity funds.

Wall Street bank Cantor Fitzgerald this spring created a real estate division and recruited two former homebuilding executives from WCI Communities to make \$400 million in opportunistic residential and commercial property investments.

In June, private equity fund manager North River Investment Management announced the formation of a \$100 million real estate opportunity fund to buy distressed commercial real estate debt as well as originate loans.

But the increased competition for capital has made it harder for opportunity funds to raise cash. According to Private Equity Intelligence Ltd., a London-based organization that tracks real estate private equity funds, 144 U.S.-based opportunity and value-added funds are looking to raise \$93 billion this year. Last year, 85 opportunity and value-added funds attracted \$49 billion.

State, county and city pension funds are the biggest source of capital for private equity funds, but growing wariness over committing more capital toward real estate all but promises to leave a good number of the first-time pools under-financed or on the sidelines.

“The interest level is strong, but it's taking longer for pension funds to make final decisions and ink commitments,” says Paul Dougherty, president of Washington, D.C.-based Perseus Realty Partners, which has launched a \$200 million opportunity fund. “If anything, they're more concerned about the economy and real estate as an asset class.”

In particular, pension funds are struggling with the so-called denominator effect. The value of their commercial real estate holdings has increased as the value of stocks has plummeted. Subsequently, pension fund allocations to real estate have artificially increased, often to a point beyond their original target percentage, says Dennis Yeskey, national director of real estate capital markets for Deloitte & Touche.

The \$176 billion California State Teachers' Retirement System, for example, raised its real estate allocation from 8% to 11% in 2006, but the stock market swoon has lifted it closer to 12%. That slight uptick percentage-wise represents an increase of nearly \$2 billion.

Additionally, an increasing number of pension funds are whittling down the number of fund managers with whom they're willing to place cash. In early July, for example, CalSTRS announced it would review some 63 commercial real estate fund managers. Although the pension fund didn't reveal a definitive goal or timetable for the review, its focus on top performers could ultimately reduce the number of managers even as it sees more capital flowing to real estate.

Indeed, pension funds are hardly giving up on commercial property, which largely anchors the alternative investment strategies of the plans. A recent survey by JP Morgan Asset Management found that 44% of respondents from public funds plan to increase their real estate allocations and 10% plan to decrease them.

In fact, Yeskey predicts that pension funds will approve further allocations this year more often than not in light of few attractive alternatives. Even so, pension funds are likely to focus on experienced fund managers, experts say.

“Seasoned sponsors will get their funds raised,” says Robert Underhill, managing director and head of the capital transactions group for Shorenstein Properties, a San Francisco-based fund manager and office landlord. “But first-time funds are going to have a very difficult time.”

— **Joe Gose**

UPTICK IN COMMERCIAL REAL ESTATE MORTGAGE DELINQUENCIES

Many experts suggest that commercial real estate faces significant distress in the months ahead as the economy wobbles, but so far mortgage delinquencies have risen only marginally.

	CMBS (30-plus days or real estate owned)	Life insurance companies (60-plus days)	Banks and thrifts (90-plus days)
Q1 2006	0.71%	0.04%	0.52%
Q2 2006	0.61%	0.04%	0.52%
Q3 2006	0.51%	0.04%	0.54%
Q4 2006	0.41%	0.02%	0.56%
Q1 2007	0.33%	0.03%	0.62%
Q2 2007	0.31%	0.01%	0.64%
Q3 2007	0.33%	0.03%	0.72%
Q4 2007	0.40%	0.01%	0.80%
Q1 2008	0.48%	0.01%	1.01%

Source: Mortgage Bankers Association