

## “REAL ESTATE MARKET OVERVIEW AND OPPORTUNITIES – LOOKING INTO 2010”

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By

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### OVERVIEW

I would like to begin this discussion on investment opportunities within the commercial real estate market with a confession...I do not speak Chinese. Why is this important? Well, I am about to speak some. If you have ever perused books or articles on how to capitalize on the “latest and greatest investment trend,” then you are familiar, no doubt, with how many of these authors will mention that the Chinese word for “crisis” – *wei ji* (pronounced “way gee”) is a combination of the two words, “**danger**” and “**opportunity**.” I myself think the point is a bit tired out.

Well, I did a little a research on the matter. And it looks like the Chinese word for “crisis” does not *really* mean “danger” and “opportunity,” that is, if you know anything about Chinese. Too bad. It was a good story and it made people feel good. The Chinese have a very old culture and always seem wise in their thinking. This revelation is the bad news. Now, the good news...in English, the word “crisis” *is* in fact the combination of the two notions, “danger” and “opportunity.” Let me explain.

Financial markets go through seasons of growth, stagnation, and recession. If the wheels really come off the economy, then we experience a “Depression.” Luckily, we do not see this very often. Whatever the case, commercial real estate is subject to the same expansions and contractions as the rest of the economy. As history has taught us, every downturn is followed by a period of recovery, just as every recovery is followed by a period growth. And so the cycle goes, round and round, quite naturally, from one stage to the next. Just look at the Dow Jones Industrial Average from its beginning (1896) to the present time. If you stand far enough away, it appears to be a linear upward sloping line. If you get closer, it is a different story...as we all know.

Occasionally, the markets get overheated. Do you remember the “Savings & Loan” bubble? What about the “technology bubble?” You could not forget the “housing bubble,” even if you wanted to. Leading economist often worry that we have an economy that is dependent on these bubbles. Several years ago, former Federal Reserve Chairman, Alan Greenspan, called these heady episodes, times of “irrational exuberance.” When that happens, the economy comes to a Wintery halt. In fact, frozen is where we have found ourselves these last couple of years.

## **“Real Estate Market Overview and Opportunities – Looking Into 2010”**

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### **OVERVIEW, continued:**

Within this natural unfolding of market ups and downs, there is a critical point between each stage.... call it a “gap.” In other words, it is a span of time when investors and institutions cautiously determine the best possible course of action to take. I like to call this stage the “Discovery Phase.” As the saying goes, no sane person wants to lose their shirt.

There is a flipside to this Discovery Phase. This “wait and see” period in the cycle, this market “gap,” as I called it before, is precisely the moment where opportunity exists. The gap is

**opportunity.**

The global economic Recession that we have witnessed through the news and in our lives, when taken just by itself, is nothing less than a crisis. It has been a complete meltdown of the intricate and fragile web that makes up our economy. We listened in real-time to the experts as the fallout unfolded, and now we are reading the “a year later” articles. Clearly, some very troubling stuff. While the current downturn may be especially cruel to some (and perhaps some of that comeuppance is a little poetic justice), what about the rest of us?

For those of us who kept our “powder dry” (a term from the Revolutionary War, not Revlon) as we watched all that once “easy money” vanish into thin air just as easily as it seemed to appear, it is now time to put real money to work into sound, reasonable, and not-to-mention, profitable investment opportunities.

Let us begin with a brief overview of the general state of affairs, and from there, we will focus and re-focus down to the real matter at hand...**opportunity.**

### **THE ECONOMY TODAY**

In terms of the general economy, I have no new bad news to tell. It is all on the table. Everyone knows the situation has been dismal – the worst Recession since the Great Depression...a trillion and a half-dollar U.S. deficit..., and so on, and so forth. The media is doing a pretty good job in covering that end of the news. In addition, since this discussion is about investment opportunities within commercial real estate, I only want to stray from the theme when it serves a point. All in all, economists are starting to talk more about how we have finally hit the bottom; although, we have to wait for the official bell from the National Bureau of Economic Research to sound. Well, that would be nice, right? That said, the following is a brief snapshot of where we stand.

I would just like to note that there are a few signs of encouragement. Gross Domestic Product (GDP), the “head honcho” of economic metrics, shrank quite a bit less (at less than 1% in the 2<sup>nd</sup> Quarter of 2009) than it did in the 1<sup>st</sup> Quarter of 2009, which had a whopping drop of 6.4%.

### **THE ECONOMY TODAY, continued:**

While this may only seem like a minor blip in the radar, GDP is so large that when a change like this occurs, people pay attention. In that same spirit, national unemployment, while continuing to go up, did so at a slower pace, from 9.5% to 9.4%. However, do not bust out the champagne just yet. Here in sunny California, the State jobless figure is up to 12.1%. Ouch! Even worse, Los Angeles County is at 12.5%. Clearly, we are still not out of the woods. In fact, we are still in shock about the size of the trees.

The real issue now with unemployment is not just the high percentage, but also the duration of how long people are staying out of work. Unfortunately, this figure is growing. As of July 2009, 33.8% of those who are unemployed have been so for six months or longer. This number is up from 29% in June. Compared to last year, when it was just 19.3%, it is no wonder why consumer spending has tanked. However, there is some recent good news about consumer spending. During the 2<sup>nd</sup> Quarter of 2009, spending dropped only 3.5%, whereas in the two previous Quarters, we had declines of 6.09% and 8.52%, respectively. This will be a very important Christmas shopping season to watch and measure. There is a slight wisp of optimism in the air, but it might not translate to holiday spending.

### **REAL ESTATE OVERVIEW**

On a national, regional, and local level, the commercial real estate sector has deteriorated dramatically on all fronts and across all sub-markets. This includes Office, Retail, Industrial, and Multi-Family properties. In other words, commercial real estate has been hurt and hurt badly. Here is a snapshot of the issue at the national level:

#### **Office:**

Office vacancies should reach 16.9% at the end of the year and 17.9% by 2010. Rents are projected to drop 8.6%, with increases not expected until 2011.

#### **Retail:**

Retail vacancies reached 10% in the 2<sup>nd</sup> Quarter of 2009. Effective rents dropped by 1.1%, while negative absorption is projected to hit 27 million square feet by the end of the year. This is up from 7.5 million square feet in 2008.

#### **Industrial:**

Negative net absorption is expected to peak at 65.8 million square feet by the end of 2009. Vacancies reached 11.4% in the 2<sup>nd</sup> Quarter, up from 10.2% in 2008. Effective rents dropped 3.7% during this same period.

**REAL ESTATE OVERVIEW, continued:**

**Multi-Family:**

Apartments, which are typically a resilient property type, are suffering a historically low period. According to New York-based research firm, Reis, less than 900 Apartment units nationwide were absorbed in the 2<sup>nd</sup> Quarter of 2009, which is less than 1/10<sup>th</sup> the amount during the same period in 2008. If the trend continues, this absorption figure does not bode well for the projected new inventory of 110,000 units in 2009. Vacancies are at 7.6% compared to 7.3% in the 1<sup>st</sup> Quarter, with an expected peak to surpass 8% by 2010. Effective rents are down 0.9% from 1<sup>st</sup> Quarter, with an anticipated drop of 2.6% by the end of the year.

**Single-Family:**

Home prices continue to be down about 30% from their peak in 2006, but analysts think we have reached the bottom. The Standard & Poor/Case-Shiller “U.S. National Home Price Index” reported an increase of 1.4% from the 1<sup>st</sup> Quarter to the 2<sup>nd</sup>. This is the first increase in 3 years. Also, sales volumes of existing homes were up 7.2% in July from June.

**THE COMING TSUNAMI**

Now that we have a general understanding of the larger economic picture, let’s look at the changes in the market place and the opportunities that will come from it. When I commented earlier about how I have nothing new to add about the current economic crisis, I fibbed a little. Here is the news:

By every major indication, the commercial real estate market is on the verge of experiencing a fallout on the scale of the recent housing collapse. In fact, if you just count dollars and cents, we have already surpassed it. I assure you, this not a secret. It simply has not garnered the level of media attention one would expect for impending market doom. Too many other doom-oriented distractions, I suppose. Although, as I scan the newspapers, it is now starting to make the front page.

The current White House administration, through the efforts of Treasury Secretary Timothy Geithner and Federal Reserve Chairman Ben Bernake, is feverishly working to stave off the coming commercial mortgage apocalypse. I will go more into their efforts later. “Opportunity investors,” which is the politically correct term for the folks behind “vulture funds,” are absolutely counting on commercial real estate to head south. More on these guys, too. So, what am I talking about? It is not that complicated and much of it will have a familiar ring.

**THE COMING TSUNAMI, continued:**

Recall, if you will, the recent events surrounding the housing bubble and subsequent bust. Basically, the people on Wall Street – as clever as they are – figured out a way to make a lot of money off bad home loans. The cash that was generated from the securitization of sub-prime mortgages, in turn, pumped more fuel into the machine of making even more bad loans. The philosophy was similar to those “crazy deal” furniture commercials that advertise, “Buy now, and pay later,” “12 months just like cash,” and the best one, “No credit / no problem!”

In other words, lenders enabled borrowers to live well-beyond their means. The pitch was that when it came time to refinance, the value of their home would have increased enough to make an otherwise burdensome mortgage a non-issue. I am sure that there were some aggressive appraisals that also contributed to the euphoria. Since a home is a part of “the American dream,” it was not too hard to get property owners excited about committing to something that would only serve to make the dream better. For many the dream became a nightmare.

By now, the housing crisis and its effects on the greater financial structure is an all too familiar story. But this woeful tale may just be the first act of a double feature. Instead of housing, this time the main character is the commercial real estate industry. As I said earlier, just read the financial section of the newspaper and you will see that there are growing signs of the upcoming commercial crisis.

Much like the residential sector, much of the money that fueled commercial development and transactions came from relaxed underwriting and the securitization of debt. Some of you may have heard of Commercial Mortgage Backed Securities (CMBS for short). If not, please allow me to summarize.

Commercial Mortgage Backed Securities are essentially bonds tied to loans made to investment property owners. Let us say Bob Smith (a make-believe investor) wants to buy an Office building. As is often the case, Bob lacks the needed cash, so he visits the bank to get a loan. The bank gives him a loan and then files it away with all their other investment property loans. One option for the bank is to keep the debt on its books and collect Bob’s monthly payments. Another option is for the bank to pool together all of its other loans of Bob’s type and convert them into a bond. The bank usually sells these bonds to the Wall Street boys who “know what they were doing.” Investors from all over the world can then buy pieces of this clumped together security, just as if it were a stock. Further, they slice and dice those securities into more pieces (called “tranches”) than one of those food choppers that are sold at the county fair. Each tranche represents a different risk/yield segment because not all borrowers are created equal. So, whether the buyer needed AAA or high yield for their investment portfolio, they could get it. What a life.

### **THE COMING TSUNAMI, continued:**

To be clear, there is nothing inherently wrong with a CMBS or, for that matter, with securities backed by residential properties. When practiced correctly, these financial instruments are an important and useful investment vehicle for lenders, borrowers, and third-party investors.

However, there is a rub. As with the housing bubble, banks began to issue too many of these securitized loans to developers and property investors with an over-zealous optimism about which way the market would go. People got too greedy. Traunches that were rated a certain quality were really a couple of levels lower, or even lower than that. Everyone predicted that property values, tenant demand, and rents would continue to go up, while vacancy rates would go down. Banks did not anticipate a housing market collapse that would eventually disrupt the larger economy, including commercial real estate.

I suppose you are wondering, and rightly so, “What does it all mean?” We all know what happened with the housing market fallout. The answer is bank failures, government bailouts, bankruptcies, and high unemployment. Now, let’s look at the details of the commercial situation.

### **FALLOUT**

The reason that the increasing potential for major commercial fallout has yet to blast through the media is twofold:

1. It has not fully happened yet, and;
2. It is not entirely obvious how the situation will play out.

Recent and aggressive government efforts to fend off a collapse are underway. Banks and investors are also redrawing their game plan for what is likely to happen in the case of disaster. It might still be too soon to tell what exactly will happen, but I will give you the facts about what is gearing-up.

The chief issue of concern is the billions upon billions of dollars in commercial real estate loans, both securitized and non-securitized, that are set to mature (come due) in the next few years. As was the case with the housing crisis, commercial property owners will have to face the big question of what to do when the time comes to refinance their mortgages, and they simply cannot. The potential for defaults and foreclosures is staggering.

Here is a quick overview of the numbers:

- Banks are presently carrying anywhere from \$1.5 to \$2 trillion in commercial real estate loans. \$400 billion of this is due at the end of 2009, with the remainder set to mature by 2012. The projected default rate is around 5%.

**FALLOUT, continued:**

- There is almost \$750 billion of CMBS loans outstanding, \$250 billion of that is coming due at the year’s end. The delinquency rate in July of this year was 3.14%, which was six times greater than it was a year ago.
- Approximately 3,100 CMBS loans, equaling \$49.1 billion, are already in “special servicing” caused by either default, bankruptcy, or delinquency. This number is expected to double by the end of the year.
- Commercial property values are down as much as 50% from their peak in 2007.
- Commercial property sales are down about 90% off their 2007 peak, in part because lenders have tightened debt issuance from 55% to 60% of loan-to-value, compared to 75% to 80% in prior years.
- Consistent with the above bullet-points, underwriting standards for new loans are as strict as they have ever been. Further, the loan assumption standards are tougher and more onerous than the ones for new loans.

First, let us look at what plagues the CMBS market. The original appeal of bundling-up commercial mortgages and selling them off into pieces and various risk-levels is that it injected unprecedented amounts of money into commercial real estate development and investment. As long as values continued to go up, everybody got paid. However, since the rapid decline in values, rents, and occupancy, a slew of property owners now have buildings that are worth less than the mortgages used to acquire them. Just as when sub-prime residential borrowers woke-up to the chilling reality that their dream home did not double in value in just two years, investors are now finding themselves similarly underwater on their high-rise buildings and shopping malls. Their golden goose has turned into an ugly duckling. It is kind of like the game of musical chairs – it is fun until the music stops and people start losing chairs to sit on. Kids were unknowingly learning the harsh reality of the business world at a young age.

Since CMBS loans became one of the chief lending instruments during recent years, the issue becomes one of volume. The size and scope of troubled assets is simply too great for what the market can absorb. Let us revisit a now iconic example.

You have heard about AIG, the giant insurance company, which is the largest recipient of government bailout money. You are still wondering “why?” Well, they got involved in all this CMBS business by providing a type of insurance to cover default of the bonds. This insurance had an interesting name – “credit default swaps.” Since no one expected default rates to skyrocket, they raked-in huge fees by being the largest provider of this special insurance. Their stock was a high-flyer. The bonuses they paid to executives were massive. The CEO was touted as a man of great financial genius. And then one fine day, all these great things reversed. Lucky for them, they were deemed “too big and too important to fail.”

**FALLOUT, continued:**

To complicate matters even further, CMBSs are just one side of commercial real estate debt that faces mounting pressure. Banks have about \$1.7 trillion of commercial mortgages and construction loans on their books that were not packaged and sold. They are generally the smaller “every day” loans that a good bank makes to a good customer. Due to rising defaults, banks are presently bracing for losses anywhere from \$115 billion to \$150 billion. Just to put this perspective, this is about equal to what has been lost in the CMBS market from 2005 to 2008.

Now here is where things get really interesting (as if you were bored up to now). Unlike residential loans, of which most were issued by a handful of giant institutions, the commercial mortgages in question came mostly from regional banks. More than 3,000 banks nationwide have 300% of their “risk-based capital” (the primary measure of a bank’s financial strength) tied-up in commercial real estate loans. Unlike their counterparts on Wall Street, when it comes time to collect on the loan principal coming due, and the money is just not there, these smaller Main Street banks may not be – as the saying goes – “too big to fail.” In fact, we have already seen nearly 100 regional banks fail this year in the United States.

So, where is this bad news headed? I was around during the real estate crash in the 1990s, and I am reading a lot now about similarities between the two downturns. In fact, some analysts predict we are now facing the potential for a bigger bust. Rents and vacancy rates are already starting to mirror the 1990s, while property values are down as much as 50%. In fact, commercial values are off peak by a greater percentage than with the housing market. The net result of all of this is stricter underwriting criteria due to the housing crisis, a credit crunch, and a slew of commercial mortgages that will not qualify for refinancing upon maturing. As one investor recently said: “What’s going to happen when billions of dollars can’t be repaid?” Yes, there are those who talk of the possibility of a “soft landing” if we do not all panic and approach this with prudence (whatever that means), but we need to wait until 2010 and see what happens before we see if the lava flow can be diverted. If there is a Batman, then it is time to shine the Bat Light.

**GOVERNMENT RESPONSE**

Now that we have covered the storm, let’s examine both the government response and the opportunities these changes to the market will bring.

With the CMBS market essentially broken, and billions dollars of troubled debt weighing down banks, the government has recently taken certain aggressive measures in order to avoid another all out market collapse.

**GOVERNMENT RESPONSE, continued:**

Back in November of 2008, Treasury Secretary Timothy Geithner announced a program called Term Asset-Backed Securities Loan Facility, or what is otherwise known as TALF. Initially, TALF only facilitated the issuance of newly originated asset-backed securities. These included student loans, credit cards, auto loans, and small business loans. The original spending ceiling for the program was \$200 billion. However, times have changed since November 2008.

Today, the TALF budget has grown to \$1 trillion. Added to this, in March of this year another program was created under the umbrella of TALF. Ladies and gentlemen, I am pleased to introduce you to the Public-Private Investment Program or P-PIP. Perhaps you saw the news the day the P-PIP was announced? Wall Street fell in love and the Dow jumped 500 points in a short time. Here’s how the program works:

The Public-Private Investment Trust is designed to aid the purchase of toxic assets from banks, with the idea of making the terms so sweet that investors cannot refuse. Sort of like when Mom mixes something sweet with the bitter medicine, the Federal Reserve will guarantee 85% of the purchase price of legacy loans, while the Treasury will cover the remaining 15%. In the end, the numbers work out to about \$6.00 of government money for every dollar of investor money. Sweet!

What does the P-PIP cover? The first part of the program covers toxic residential loans. This is called the Legacy Loan Program. The second part of the program – the Legacy Securities Program – takes aim at mortgage-backed securities that were once-upon-a-time “Triple-A” rated, in addition to commercial mortgage-backed securities that are presently “Triple-A” rated. As for money allocated, the Treasury and the Federal Reserve are committed to spend up to \$500 billion.

Despite P-PIP’s warm reception, the market has been slow to act on taking advantage of the opportunity. Part of the issue is that these deals take time to hash-out. Also, it is no surprise that investors are a little cautious about where they put their money these days. In that same vein, investors who have been building-up their money chest for some bargain shopping, just want to make certain that prices cannot get any lower.

Understanding the need to let the market feel out the situation, the Treasury decided to extend TALF from its original deadline of December 31, 2009 to March 31, 2010. For the CMBS portion of the program, there is even more breathing room, with an extension pushed back until June 20, 2010.

### **GOVERNMENT RESPONSE, continued:**

Why did the government do this? While TALF was originally intended as a boost for consumers and small businesses, the magnitude of existing toxic mortgages, including those from commercial real estate, have had a two-fold effect. First, banks cannot return from the dead until they find a viable means of squaring off their current bad debt. Second, and which follows from the first issue, is that banks are in no position to do what they there are designed to do, which is to lend money to people who want to develop and buy buildings.

So while the government’s move has its share of detractors – on both sides of the political isle, I might add – the general feeling on Wall Street and within the commercial real estate investment community is that this is exactly the kind of medicine the industry needs.

### **BREAKING NEWS**

“This just in” as they say in the broadcast news business. As I was preparing this paper, an important change occurred that will benefit the current CMBS situation and commercial real estate industry in general. The Treasury announced on September 16 that it is going to loosen restrictions on CMBS loan modifications. What restrictions, you ask?

Let us say our earlier-referenced investor, Bob Smith, has a commercial real estate investment, and his mortgage is part of a CMBS. If, for whatever reason, it is becoming increasingly difficult for Bob to make payments (but he is still making them) on the debt and he wants to talk to someone about working out some better terms, he is out of luck. The way CMBSs work, a borrower has to be delinquent before negotiations can begin.

Here is the reason: when a bank pools together a bunch of mortgages for the purpose of converting them into a security, they pass it off to a Trust (called a Real Estate Mortgage Investment Conduit, “REMIC” for short), which is then administered by a servicer. The servicer represents the investors on the security-end of the arrangement. Furthermore, Trusts have special tax rules which states that 95% of the earnings are not taxed. All that money goes straight into the pockets of the various investors. The condition for this favorable tax set-up is that mortgages, which are still in good standing, cannot be modified or even discussed ....**even if danger is on the horizon**. Therefore, if Bob is taking money out of his “Christmas Club” account in order to keep the loan current on a troubled asset, he cannot ask or even inquire about some relief. He has to be in default for that first conversation to occur. The risk of being in default as a negotiating tactic is that the holder of the Note may have other plans for the asset, including not having Bob in the picture any more. The whole thing is a “Catch 22” (a frustrating situation in which one is trapped by contradictory regulations or conditions).

**BREAKING NEWS, continued:**

The significance of the Treasury’s new “guidance” (as they call it) is that CMBS servicers now have the ability to modify individual loans if they smell trouble or are approached by the borrower, but without causing a tax penalty to the investors who bought the CMBS issues. This is also great news for borrowers because they can now actually do something (generally a modification of loan terms) to prevent defaulting on their loan, which will ultimately help them from foreclosing on their property. Therefore, our man, Bob Smith, can have a business-like and forthright discussion with the CMBS servicer before real trouble occurs. This “guidance” was also put into effect for residential CMBS loans, so the commercial interest groups lobbied very hard in Washington for this relief. I am pleased with this decision.

But not everyone will be equally jolly with the news. In fact, some investors, knowing the strict guidelines for the CMBS market, have been waiting patiently for loans to mature, and with that, the heap of foreclosures that are sure to follow. This brings me to my next topic on “opportunity investors.”

**A WOLF IN SHEEP’S CLOTHING**

Now that we have an understanding of the commercial real estate market’s fragile state, it is worth noting that as early as 2007, a certain class of investors have been waiting anxiously for bad times. It is not because they are worried about taking a bath on their investments. Rather, they have been waiting for the other guy to experience a threshold of pain. Just like the saying, “The only thing better than making a deal is seeing your best friend lose one.”

There is another old saying that you may have heard, “The time to buy is when there’s blood on the streets.” Sounds pretty harsh, right? Perhaps Warren Buffett captures the spirit of my point, but with a little more of that Omaha charm, “You pay a very high price in the stock market for a cheery consensus.”

If you have not already guessed, I am talking about the group of folks called “opportunity investors.” Behind closed doors we call these investors “grave dancers.” The express purpose of these harshly-nicknamed characters is to put together large investment pools of money (“funds”) and then seek out assets in severe distress. And you guessed it, they swoop them up at bargain-bin prices. These players are poised, ready, tan, rested, and waiting because they have a hunch that values may slip down even further. These opportunists look at the big picture and view the current economic downturn as a wonderful entry point for acquiring valuable properties at a deep discount.

**A WOLF IN SHEEP’S CLOTHING, continued:**

As I mentioned before, some folks foresaw disaster early on and began raising enormous amounts of cash in order to acquire deeply discounted debt and properties. In 2008, at least 144 U.S. based funds started up with spending objectives of about \$93 billion. A year before, when the market was just beginning to show some problems, 85 U.S. based funds raised nearly \$50 billion in anticipation that conditions would deteriorate. The attitude then, as it is now, is: “Too bad things are getting bad, but look how much money we’re gong to make.” These funds go by many names – “opportunity fund,” “value fund,” “distressed asset fund,” and so forth. The purpose is rather clear. Some of the greatest real estate fortunes were began during the Savings & Loan crisis of the late-80s. Probably the best known player is Sam Zell, who started as a rich man at the time, and then became even richer when he sold Equity Office to Blackstone for \$36 billion. The start of Equity Office was during that late-80s period, and Sam is one of the best known “grave dancers.”

Below are some examples of the kinds of real estate activity that have made headlines. I am not singling these folks out – there are so many to choose from – but they are considered household names in the commercial real estate community:

- Harry Macklowe, one of New York’s major real estate players, lost ground this year on seven of his cherished Manhattan towers, including the iconic GM Building, after defaulting on \$7 billion in debt. I read that he is down to his last \$2-3 billion.
- The largest real estate deal in history, an enormous apartment venture in New York City, is now in severe dire straights. Tishman Speyer, one of the world’s biggest developers/investors, shepherded the project for a total of \$6.3 billion. The property is now estimated to be worth only \$2.13 billion.
- If Tishman Speyer does not already have enough grief, it has also defaulted on its \$2.8 billion acquisition of 28 Class-A office buildings in Washington, DC, many of them are in close proximity to the White House.
- Maguire Properties, one of our Los Angeles’ big boys, recently gave up seven Southern California area office buildings. All of them were trophy assets. They posted a loss of \$345 million on the deal.
- In an effort to reduce an overwhelming \$7.9 billion debt-load, the Santa Monica based Macerich Co., just sold their \$300 million stake in Queens Center Mall to the Ontario Teacher’s Pension Plan. Macerich is also in the process of trying to close two more substantial deals.

**A WOLF IN SHEEP’S CLOTHING, continued:**

It is important to note here that unlike the housing boom and bust, the above entities are not sub-prime borrowers. They are some of the biggest real estate developers and investors around. While it is true that they were significantly over-leveraged, it is also true that some of the most successful figures in the industry are not immune to economic hardship. But as the saying goes, “One person’s loss is another’s gain.”

Here is what is playing out in the big leagues of property investment. In the case of distressed investing in the CMBS market, the strategy is typically one of two methods. First, investors will buy up shares of the CMBSs with the hope that the bottom has been reached and the only place to go is up. The Public-Private Investment Partnership deals expressly with this type of scenario.

The second approach, which we are likely to see a lot more of, will take the form of investors buying out the majority stake in a CMBS in order to gain leverage on the property itself. As will always be the case, a good property in a good location is a good thing to have. Remember the adage of good real estate: “Location, Location, and Location.” This is a rather aggressive move on the part of the vulture investor, and such instances are likely to not go down without a fight. Here is why - when an investor tries to buy the biggest piece of a troubled CMBS, and they are only paying pennies on the dollar, it renders the remaining subordinate shares essentially worthless. This, I might add, does not please the smaller shareholders. A recent example follows that demonstrates this very thing.

Not long ago, a fund called Max Property tried to acquire a CMBS that Citigroup had a stake in. Citigroup did not have the largest chunk of the bond, but just enough of it that they were not about it let Max Property eat their lunch by lowering the value of Citi’s interest. Citi’s response has been to stop Max in its tracks by making a counter-offer. With billions upon billions of dollars at stake on both sides, I expect a lot more of this type of “battling it out” in the near future.

Turning away from opportunity funds, another important sector to watch is in Real Estate Investment Trusts, otherwise known as REITs. REITs have raised almost \$15 billion this year in new equity. However, this is not to say that REITs have had a “walk in the park” lately. In March of this year, REITs were down 75% off their peak. Although they are back up again, it has been a slow climb. Presently, REITs are still off by 60%, whereas the stock market is down about 40%. As of this writing, 2009 has seen significant improvement in the stock market, but it is still off its recent high.

One of the chief struggles for REITs right now is the state of the pension fund market, which have favored REITs for some time. The 50 biggest pensions are only expected to spend about \$5 billion this year in REIT investment. Last year that figure was \$17 billion, while in 2007 it was more than double at a whopping \$36 billion. In short, pension funds are experiencing a bit of real estate property shopping fatigue.

### **A WOLF IN SHEEP’S CLOTHING, continued:**

Despite REITs taking some serious blows, it looks like they will make it through just fine. This is in part due to the fact that from 2006 to 2007, they sold more than they bought. A wise move that made their load about \$97 billion lighter.

REITs also have a great track record. Therefore, any major corrections they have experienced are overshadowed by the fact that they have typically performed better than other popular indices and funds.

### **OPPORTUNITIES AND CONCLUSION**

At the start of the annual Indianapolis 500, which is the leading car race and sporting spectator event of the year, the announcer calls out, “Ladies and Gentlemen, start your engines!” What happens next is that 33 cars, with a combined 22,000+ of horsepower rev up in preparation for the next three hours of man vs. man vs. machine.

Well, I think that is where we are now in commercial real estate. Investors should be “starting their engines” for what will be an excellent buying opportunity.

Yes, this could be an article that only details all the bad news about man-made events of the terrible world economy, the US economy, the California economy, the Southern California economy, the housing depression, the stock market bust, the lending bust, and so forth, but it is not. Some of that was necessary in order to explain how we got here. As true as all the bad news is, you have probably had enough, and I do not have any new way of adding to the drama.

I have no new benchmarks to prove previous writers right or wrong. The good news is that this is an article about opportunity. As former President Ronald Reagan used to say when telling a story about a boy who was excited about seeing a lot of horse droppings around the house, “With all this manure around here, there must be a pony somewhere.” I know that a lot of negative news was cited here, but it was only as a backdrop to make a point. Like the little boy in the story, I think there is a pony somewhere.

The bard, Shakespeare, wrote about tragedy. So did the Greeks. Many of them had their roots in cosmic events. Romeo and Juliet were “star-crossed lovers,” Hamlet saw the ghost of his father, Odysseus angered the Gods, so he was sentenced to a ten-year awful trip to get home, and so forth. On the other hand, Cassius’ words in *Julius Caesar* to a fellow conspirator balance it out, “The fault, dear Brutus, lies not in our stars, but in ourselves...”

**OPPORTUNITIES AND CONCLUSION, continued:**

The economic events of today are not the fault of the stars; they are the result of “ourselves.” Every down cycle is generally a result of too much of something. The something is usually money. The sultry actress, Mae West, was famous for saying, “Too much of something good is wonderful.” She probably had something other than easy and cheap credit in mind. When you look at a long term chart of lending volume (housing, commercial property, and consumer goods), you will see that every 5-10 years there is a virtual explosion of dollars committed to real estate, businesses, and ventures. It is always fun while it lasts.

My theme in this article is that we are now entering the period of opportunity. By “opportunity,” I am referring to buying opportunity. I am a believer in cycles and the fact that history repeats itself. Yes, we are smarter, but a new generation (or even the same generation) makes the same mistakes. When money is involved, look out! Jesse Unruh, who was a giant in California politics 30+ years ago, once said, “Money is the mother’s milk of politics.” Well, money has the same nourishment value when it comes to real estate, stocks, business, etc. When we have too much, and it is not wisely used, disaster is sure to follow.

We know that we are in the worst Recession since the Great Depression. Some say the worst economy since World War II. Both are right. I am always reminded how many very smart people have had a hand in our economic policy since the Great Depression (late-20s to the mid-30s). Since that period, we are now on our thirteenth President (Roosevelt, Truman, Eisenhower, Kennedy, Johnson, Nixon, Ford, Carter, Reagan, Bush, Clinton, Bush, and Obama). During that same time, we have had 25 Secretaries of the Treasury, and nine Chairman of the Federal Reserve. With all this brainpower, we are now in our thirteenth Recession since the Great Depression. So much for the theory of learning from the past.

I am a believer that we survive and come back even stronger. Since the Great Depression, we have survived:

- **World War II**
- **Korean War**
- **Cuban Missile Crisis**
- **Cold War**
- **Kennedy Assassination**
- **Vietnam War**
- **Oil Embargo and Gas Lines**
- **21% Prime Rate**
- **Black Monday**
- **Persian Gulf War I**
- **Savings & Loan Crisis**
- **9/11**
- **Persian Gulf War II**
- **Dot.Com Bubble and Burst**
- **Countless Natural Disasters (Fires, Earthquakes, and Hurricanes)**

**OPPORTUNITIES AND CONCLUSION, continued:**

Now let’s put the current situation in crystal clear perspective. A recent quote from the head of Cornell’s real estate program says it pretty well, “For the opportunity fund with the resources, it’s time to make a killing. In 10 years, people will look back at 2009 as the year fortunes were made.” A recent *Forbes* article stated: “...Now is a once-in-a-generation chance to reload your property portfolio.”

In my opinion, we are in the “Discovery/Recovery” stage of this economic cycle. I can feel it and smell it. Regarding Fed Chairman Bernanke comment that the Recession is likely over, I gather that he knows what he is talking about. Since the financial measure of the economy is a “look-back” figure, we will not know if he is right for many months, but I am starting to feel better.

In conclusion, the next opportunity for real estate wealth begins today.