

Financial Foresight

Challenges facing investors, owners, and lenders in today's distressed real estate market



Investors, owners, and lenders are facing enormous challenges resulting from an unprecedented level of turmoil in the U.S. commercial real estate market.

As of January 2010, more than \$174 billion worth of U.S. real estate was in distress. Nearly 80% of this number – \$136 billion – consists of “troubled assets.”¹ This classification includes situations where mortgages are delinquent or in default, liens have been filed, or foreclosures are in process and/or an administrator, receiver, or special servicer has been appointed. Properties where development is stopped before completion or the sole tenant is in liquidation also qualify a property as distressed, as do properties owned by any entity that is in bankruptcy or administration.

Restructured and modified loans account for another \$14 billion of distressed assets, as do “lender real estate owned (REO)” properties, where lenders have taken title. Only \$17 billion of distressed real estate assets have been resolved to date.

“The fact that the value of distressed properties is more than eight times the value of resolved properties shows how far the real estate industry has to go before we return to more traditional levels of stability,” says Dorothy Alpert, a principal with Deloitte LLP. “With approximately \$1.5 trillion worth of commercial mortgages coming due between 2009 and 2013, the problems are far from over.”

Evolving Sources of Capital

For many years, savings and loan (S&L) associations were a leading source of real estate debt capital, accounting for more than a quarter of all commercial and multifamily mortgage loans as recently as 1980. After the S&L crisis of the late 1980s and early 1990s, commercial mortgage-backed securities filled the void created when many thrift institutions collapsed or reduced their participation in the marketplace. Today, thrifts provide just 6% of real estate debt capital.

Looking ahead, the marketplace is expected to change even more, as commercial mortgage-backed securities, including some supported by the Federal Reserve’s Term

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¹ Source: Real Capital Analytics, 1/7/10

Asset-Backed Securities Loan Facility; global private equity funds; and sovereign wealth funds play bigger roles as sources of real estate debt capital.

“Global private equity funds have raised more than \$190 billion for real estate investments that they have not yet deployed. Nearly two-thirds of this so-called ‘dry powder’ is specifically targeted for U.S. commercial real estate,” says Guy Langford, a principal of Deloitte & Touche LLP who leads the firm’s Merger and Acquisition Transactions Real Estate Practice. “Many of these funds are pursuing distressed assets in multiple segments – including retail, hotel, and health care – as well as buying debt at a discount. They also are interested in acquiring banks with established origination platforms, and buying pools of assets from the Federal Deposit Insurance Corporation.”

Sovereign wealth funds have considerable financial resources to deploy in U.S. commercial real estate. The Abu Dhabi Investment Authority, for example, has \$75 billion currently committed to real estate and the Government of Singapore Investment Corporation has another \$30 billion.

Such funds have already made significant investments in U.S. commercial real estate. For example, sovereign wealth funds have acquired such landmark New York properties as the Chrysler Building, the General Motors Building, 125 West 55th Street, and 540 Madison Avenue. Several funds are also evaluating possible investments in distressed Class A office or five-star hotels in some gateway U.S. cities.

U.S. public real estate investment trusts (REITs) are another growing source of capital; these markets were fairly active during 2009, raising just under \$30 billion. Most of this capital was raised in the mortgage REIT market as well as in the hospitality or hotel REIT space. Some of the capital has enabled REITs to de-leverage as well as to target distressed opportunities in the marketplace. In addition, U.S. non-traded REITs have total capitalization of approximately \$71 billion, with the strong ability to deploy against distressed opportunities.

Many real estate and financial services professionals believe that more capital will be raised through public markets to pursue distressed debt and asset opportunities. According to a recent, informal online poll that Deloitte conducted among more than 1,000 professionals, 50% agree that more capital would be raised and 24% believe that more capital might be raised, once existing capital has been deployed.

Do you expect there will be more capital raised through public markets to pursue distressed debt and asset opportunities?

Yes	50%
Maybe, once existing capital has been deployed	24%
No	8%
Don't Know	18%

Few real estate and financial services professionals, however, believe that the U.S. real estate debt origination markets will begin to open up much before mid-2010. According to Deloitte’s recent online survey, more than half say that the U.S. real estate debt origination markets will not begin to open up until the second half of 2010 (34%) or later (29%). Less than one-fifth of respondents believe the markets have already begun to open up (4%) or will do so in the first half of 2010 (15%).

When do you believe U.S. real estate debt origination markets will begin to open up?

Already have	4%
First half 2010	15%
Second half 2010	34%
After 2010	29%
Don't know	18%

Factors affecting real estate valuations

By any measure, valuations in commercial real estate have been trending downward for several years, with no real signs of improvement on the immediate horizon. Several factors are contributing to this trend:

- **Unemployment continues to climb:** Real estate valuations are impacted by demand, and demand is driven by factors like employment; when unemployment rises, demand falls off. Unemployment increased steadily, increasing 0.4% in October to 10.2%, the highest rate since April 1983. Until unemployment starts to decline, it will be difficult to fill vacancies in commercial real estate.
- **Vacancy levels are rising:** The historic vacancy levels in the four principal classes of commercial real estate – office, retail, multifamily, and industrial – are approaching, and, in some cases, have even surpassed vacancy levels that occurred in the early 1990s, during the last severe real estate downturn.
- **Sales volumes have plummeted.** The volume of commercial real estate sales in 2009 has plummeted, off close to 90% from its peak in the second quarter of 2007.
- **Capitalization rates are increasing.** The capitalization rate represents the yield that real estate owners want based on their estimate of a property’s net operating income to determine what they are willing to pay for it. It indicates what investors want to be paid for the risk they assume when buying an asset. In 2001, property capitalization rates for the different asset types ranged from slightly above 8% to somewhere just below 10%.

- **Asset yield requirements are much higher.** Just two years ago, in 2007, borrowers were able to obtain a blended asset yield of 7.4% by borrowing 75% of the purchase price for the first mortgage (at a rate of 5.5%), adding 10% in mezzanine debt (at a rate of 10%), and adding the rest in owner's equity (at a rate of 15%). Today, borrowers could probably borrow only 60% of the purchase price at a higher interest rate (7%) and would have to raise the remaining 40% through private equity (at a rate of 18%), for a blended rate of 11.4%, which is 400 basis points higher. That is a significant move in yield expectations, which directly affects value.

As an illustration, an asset in 2007 with net operating income of \$1 million and an asset yield or capitalization rate of 7.4% would have a value of \$13.5 million; a similar asset in 2009 with a capitalization rate of 11.4% would have a value of only \$8.8 million, or 35% less assuming no change in capitalization rate.

"It is very easy to have a significant hit to value when you look at lack of liquidity, pressure on net operating income and the alternatives that investors have to achieve higher yields for themselves," says Constantine Korologos, a Managing Director with Deloitte Financial Advisory Services LLP who represents both buy and sell sides of distressed real estate transactions, debt restructuring, workouts, and valuation matters. "If you want to get investor dollars into lower-valued assets, you need to pay those investors more."

Pockets of Prosperity

Although real estate values declined, there are pockets of prosperity. Commercial real estate enjoyed boom years from 2005 to 2007 due in part to the vast amount of liquidity that was available. Investors were able to borrow a lot of money, and borrow it cheaply. That allowed them to effectively pay more for properties because they were able to get significant leverage on the money they invested. From that peak, some market indicators show that same level of pain. Real estate values in Washington, D.C., for example, are benefiting from employment growth in the government sector, and have not seen as significant of a decrease.

Some real estate and financial services professionals believe that real estate values are beginning to bottom out. According to Deloitte's recent online survey, 18% say real estate values have already reached their lowest point and 50% expect real estate values to bottom out in 2010.

When will commercial real estate values hit bottom?

Have already bottomed	18%
First half 2010	25%
Second half of 2010	25%
After 2010	17%
Don't know	15%



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