

## Perspectives on Real Estate Uncovering opportunity in a distressed market



**Sir Winston Churchill once remarked,** “A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty.” While the U.S. commercial real estate industry may continue to grapple with adverse conditions in 2010, optimistic investors are seeing opportunity in a difficult market via the purchase of distressed assets.

Many expect the issues that challenged real estate owners and operators in 2009 to extend well into 2010. Among these are:

- **Declining real estate values** – U.S. commercial real estate values have decreased significantly – according to some reports, up to 40 percent across all property types – since their peak in 2007.<sup>1</sup> Job losses and declining consumer spending in 2009 have had a negative impact on all classes of real estate investments, particularly office and retail properties. Vacancies are up, which drives down rental rates and decreases value. In Midtown Manhattan, for example, brokerage CB Richard Ellis Group Inc. reports that the amount of available office space has increased by 16 million square feet since the beginning of 2008; building owners subsequently have dropped their asking rental rates by more than 30 percent since November of that year.<sup>2</sup>

Have real estate values bottomed out yet? If the fledgling real estate transaction volume that began to appear in late 2009 continues into early 2010, it should provide some clarity. Ultimately, it will likely take improvements in employment figures and consumer spending to drive demand for office, retail, industrial, multi-family and hospitality space and produce a corresponding uptick in occupancy and effective rents. As 2010 progresses, an economic recovery could create the next leg of the real estate cycle, with values bottoming out and slowly beginning to climb.

- **Debt maturity and credit access** – Declining real estate values are exacerbating another major issue for property owners and investors: debt maturity and credit access. According to Deutsche Bank, more than \$1.4 trillion in commercial mortgages will come due by 2013, and as much as 65 percent of these will have difficulty getting refinanced.<sup>3</sup>

Organizations which took out large loans to purchase property during the market’s heyday did so assuming that rents and occupancy rates would continue to rise; instead, both have fallen dramatically. When a mortgage loan comes due in this negative environment, the property owner faces difficulty replacing the original loan with one of similar size. Although capital markets for credit and debt have opened to some extent, the situation is different than before – lenders are allowing less leverage on new loans. Also, debt is more expensive, in part, because lenders are only willing to lend at a lower loan-to-value rate. Finally, the commercial mortgage-backed securities (CMBS) market, a huge source for real estate debt capital in the past decade, has virtually disappeared, severely affecting the supply of debt capital. Because of these constraints – and the fact that any uptick in value drivers for commercial real estate will probably lag the general economic recovery by three to six months – many commercial real estate owners and their mortgage holders will likely continue to struggle with debt maturity in 2010 and beyond.

<sup>1</sup> “Q&A Deloitte,” Illinois Real Estate Journal, December 4, 2009. <http://rejournal.com/news/213219-qu-deloitte>. Accessed December 21, 2009.

<sup>2</sup> Timiraos, T., Troianovski, A. “Real Estate Faces tough Recovery Slog,” The Wall Street Journal, January 4, 2010. <http://online.wsj.com/article/SB100>

<sup>3</sup> Timiraos, T., Troianovski, A. “Real Estate Faces tough Recovery Slog,” The Wall Street Journal, January 4, 2010. <http://online.wsj.com/article/SB100>

Interestingly, there appears to be a “pretend and extend” pact between undercapitalized real estate companies and their existing lenders to help retain ownership of a property until the economy improves. In this scenario, the lender says to the mortgage holder, “Given that rates are so low, you can probably still pay interest on your loan. Let’s extend that loan out three or four years, give the economy and capital markets time to come back, and the property the opportunity to return closer to its original value, and we will deal with the debt refinancing then.”

The government has signaled its support of real estate debt extensions and loan restructurings in a couple of ways: it allowed a change in the tax law for 2009 and 2010 so that a company which has to modify or cancel a debt can defer the gain for five years (until 2014) and then amortize that gain. Also, it has given guidance to the Federal Deposit Insurance Corporation (FDIC) about how to work with borrowers and how to encourage banks to work with them rather than foreclosing on assets.<sup>4</sup>

The alternative to “pretend and extend” is for the lender is to take back the property from the borrower, sell the loan or make a permanent adjustment in the loan. Many banks are reluctant to take back real estate and put it on their balance sheet, especially if the property is not making any money or requires significant management attention to restore value. If a company is managing a property well, is honest with lenders about its financial constraints, and convinces the lender that it is the best company to manage a property and bring its value forward, lenders are more likely to work with the borrower to modify or extend the loan, with the hope of maximizing returns. That appeared to be the case at the end of 2009, when quite a few loans were extended, and it is likely to continue in 2010.

Still, debt maturity issues and poor financial returns are prompting more and more real estate companies to hand back properties to their lending institutions. This is especially true with properties under construction, and properties requiring additional capital due to unprofitable operations, such as hotels. Some financial institutions, in turn, are using take-backs as a strategic opportunity to expand their real estate portfolio, manage the assets and (hopefully) profit by selling them in an improved market. Significant capital has been raised to invest in these distressed assets, and opportunistic

investors are developing strategies to work with banks, mezzanine debt holders, special servicers on CMBS securities, and the FDIC to capitalize on these investment opportunities.

• **Stalled construction** – There will likely be almost no new construction activity in any asset class this coming year. Companies may wrap up existing projects but the industry likely will see historically low levels of new construction, as there is excess capacity in almost every asset class (evidenced by the glut of office space in Midtown Manhattan and other major markets, as well as an oversupply of full- and/or limited-service hotel stock, most notably in Manhattan and select Texas markets,<sup>5</sup> and multi-family residential properties in areas such as Florida, Nevada, Arizona and parts of California). On the industrial front, high availability rates and sharply reduced construction have been the norm in the large distribution markets of Chicago and Atlanta. Retail construction activity has fared no better, with 10 major markets showing no projects in the pipeline for 2010,<sup>6</sup> and regional Mountain and Northeast markets with near-empty pipelines.<sup>7</sup> There may be select locations where it could make sense to build something new, but there is no broad-based impetus to build.

#### Bottom out, then recover

Most real estate asset classes are expected to bottom out and start to recover in 2010; rent levels will begin to recover with job growth and increases in consumer spending and GDP. Once job growth returns, hospitality and multi-family residential properties may be the first to show recovery due to the relatively short-term nature of their leases. Retail, office and industrial’s recovery will be slower, a result of the longer-term leases for those properties.

Some industry observers believe that the hospitality market has already bottomed out. Occupancy rates in 2009 were extremely low due to significant declines in leisure and business travel, which drove down the average revenue per available room (RevPAR). Many hotel operators have subsequently decreased rates, appealing to leisure travelers; combined with an uptick in business travel, occupancy rates have recently shown some improvement. How quickly hospitality will come back remains a big question. The outlook for 2010 is mixed, with forecasters expecting declines in supply and occupancy, but increases (relative to prior quarters) in demand, RevPAR and American Depositary Receipt (ADR). Although a handful of markets, including San Francisco and Atlanta, are expected to post positive room rate growth in 2010, the majority will need to wait until 2011 for a return to profitability.<sup>8</sup>

Recovery in the office market is heavily dependent on job growth. If this happens in 2010, it will benefit office space; however, many expect to see continued, significant weakness. A surplus of available office space – in part, the result of sublease space made available by companies which had to downsize – has driven down rental rates and created a very competitive market for owners. In the fourth

<sup>4</sup> “Q&A Deloitte,” Illinois Real Estate Journal, December 4, 2009. <http://rejournal.com/news/213219-qu-deloitte>. Accessed December 21, 2009.

<sup>5</sup> Torto Wheaton Research, Hotel Overview & Outlook, Winter 2010

<sup>6</sup> Torto Wheaton Research: Industrial Overview & Outlook, Winter 2010

<sup>7</sup> Torto Wheaton Research: Retail Overview & Outlook, Winter 2010

<sup>8</sup> Torto Wheaton Research: Hotel Overview & Outlook, Winter 2010, and PKF: Hotel Horizons, December 2009

quarter of 2009, average effective rents in Manhattan, for example, fell nearly 20 percent, to \$44.69 per square foot annually. Average rents in Washington, D.C. decreased three percent to \$41.77 per square foot annually. Nationwide, rents fell nearly nine percent in 2009, to an average of \$22.44 per square foot.<sup>9</sup>

There are some bright spots in the office market. The Washington, D.C. area has benefitted from the expansion of the federal government and contractors working with it. New York initially took a heavy hit from the reduction of financial services jobs; however, it seems to be turning around. Banks were more profitable in 2009 and more transactions were conducted so investment banks have stepped up hiring. In addition, New York real estate remains very attractive to foreign investors.

Retail is expected to fare a little better in 2010 than it did in 2009. Consumer spending has improved, as evidenced by better-than-expected holiday sales. Single-family home prices seem to have solidified (although it could take years for home values to truly recover), which has a big impact on retail spending. There are some indications that retail real estate may be in a position to recover before the office market. In fact, healthy retailers view 2010 as an opportunity to enhance their current space, move stores to higher-traffic locations, or selectively expand – both great pricing and strategic locations are available to retailers with ready capital.

Projections for the industrial real estate market are less clear. A weak dollar and rising U.S. exports are helping to stimulate growth; however, global trade levels are still down from a couple of years ago, reducing demand for distribution centers. In addition, industrial has been hurt by the recession and resultant corporate cost reductions, with many companies closing facilities and reducing warehouse space. Tight financing and weak demand for space have also slowed any recovery, with several quarters needed to absorb existing supply. Despite these obstacles, a few bright spots in the market are emerging, with a number of large intermodal projects in the near-term pipeline and more than half of the rail-served markets showing positive demand.<sup>10</sup>

Finally, a turnaround in the multi-family residential market could take hold in the second half of 2010, but it will depend primarily on job growth. Apartment vacancies hit a 30-year high in the fourth quarter of 2009 and rents fell three percent last year,<sup>11</sup> as many young, laid-off workers moved back home or doubled up to ride out the recession. Cities seeing the sharpest increases in vacancies were Tucson, AR; Charlotte, NC; and Lexington, KY. San Jose, Seattle and San Francisco led the decline in rental

rates.<sup>12</sup> To reverse this trend, apartment owners are enticing tenants to renew leases with an array of perks and amenities.

Oversupply is also a problem in the residential market, particularly among condo properties in Miami, Atlanta, Phoenix, Las Vegas and other warm-weather markets.

One positive for multi-family property owners is continued weakness in the single-family home market. The decline in home values, combined with stricter lending by banks, means fewer people are able to buy homes. Concurrently, falling rents make apartment rentals an attractive alternative. Many analysts believe that the level of home ownership, which rose to record highs in the past decade due to relatively easy and affordable mortgage financing, will return to more historical levels, which should help multi-family demand.

#### Where are the investors?

Capital is available and waiting to deploy, and the financing environment has improved somewhat (although it still has a long way to go), yet most commercial real estate investors have waited on the sidelines for a sense that values have reached bottom. Many of these investors may remain sidelined until better employment figures and consumer spending numbers spur a subsequent resurgence in real estate. However, some deal making that was evident during 2009 bodes well for 2010:

- Public capital markets have shown increasing interest in commercial real estate, a trend that should continue. Throughout 2009, existing real estate investment trusts (REITs) accessed the public equity and debt markets for additional capital to strengthen balance sheets, reduce leverage and prepare for future acquisition opportunities. In total, REITs raised almost \$32 billion in public market capital offerings in 2009, with IPOs accounting for \$2.6 billion.<sup>13</sup> A number of new mortgage REITs launched initial public offerings (IPOs) in 2009 and there are a series of existing private companies and newly formed “bind pools” preparing to launch a round of IPOs. Among noteworthy deals in 2009, Simon raised more than \$3.2 billion in the public capital markets with five equity and debt issues.<sup>14</sup> Vornado issued 15 million common shares in an equity offering of \$645 million in principal amount.<sup>15</sup> Starwood Property Trust Inc. and Apollo Commercial RE Finance Inc. also issued equity offerings in 2009 and Pebblebrook Hotel Trust completed an IPO.<sup>16</sup> However, toward the end of the year, two REITs cut the size of their IPO offerings in half, and five shelved their planned IPOs, pending renewed investor appetite.<sup>17</sup> Despite recent hesitancy, industry observers still believe there will be opportunities for investors in 2010 via REIT IPOs.

<sup>9</sup> Lewis, Christina S.N. “Rents Signal Rise of D.C., Fall of N.Y.,” *The Wall Street Journal*, January 8, 2010. <http://online.wsj.com/article/SB126291211587420679.html>. Accessed January 29, 2010.

<sup>10</sup> Torto Wheaton Research, *Industrial Overview & Outlook*, Winter 2010

<sup>11</sup> Timiraos, T. “U.S. Now a Renters’ Market,” *The Wall Street Journal*, January 7, 2010. [http://online.wsj.com/article/SB126282425648418817.html?mod=WSJ\\_Real+Estate\\_LeftT](http://online.wsj.com/article/SB126282425648418817.html?mod=WSJ_Real+Estate_LeftT). Accessed January 9, 2010.

<sup>12</sup> *Ibid*

<sup>13</sup> NAREIT, *REITWATCH*, December 2009

<sup>14</sup> Thomson/Securities Data Corporation database

<sup>15</sup> *Ibid*

<sup>16</sup> *Ibid*

<sup>17</sup> Tsang, Michael and Childs, Mary. “Chesapeake Lodging Trust Shelves \$250 Million IPO,” [www.bloomberg.com/apps/news?pid=20601087&sid=agUfseib0Xn4&pos=7](http://www.bloomberg.com/apps/news?pid=20601087&sid=agUfseib0Xn4&pos=7), Accessed January 29, 2010

- Foreign investors continue to view the United States as a relatively stable economic environment and commercial real estate as an appealing investment, with the potential for good returns on a risk-adjusted basis. In 2010, the United States should see significant foreign capital coming from Asia (especially China and Korea), German investment funds, and the Middle East. To enhance the attractiveness of U.S. real estate, industry organizations have been working to assure that U.S. tax policy does not discourage foreign investment. In January 2010, a bill was introduced to modify the Foreign Investment in Real Property Tax Act (FIRPTA), which places restrictions on foreign investment in U.S. real estate, in an effort to facilitate more foreign capital investments into the United States.

Concurrent with the influx of foreign capital, U.S. investors in 2010 are expected to spend more of their real estate dollars in their own back yard. Looking at the past three to four years, substantial U.S. capital was invested in foreign real estate, particularly in emerging markets, to take advantage of superior returns. Now, however, more of that capital will be staying in-country, at least for the near term. For well-capitalized players – whether they are existing REITs or funds that have been raised to take advantage of the depressed conditions that exist today – there are significant, broad-based opportunities (both geographically and across property types) to make distressed asset acquisitions, whether from banks that took back properties or property owners themselves. Thus far, however, surprisingly few properties have come to market; for those that have, competition among prospective buyers has been fierce. Fortunes were lost in the past couple of years; many industry watchers think there could be fortunes made in the next couple and are acting accordingly.

### Opportunistic buyers; realistic sellers

Will 2010 be a positive year for U.S. commercial real estate? The outlook is, at best, uncertain. The sector likely will see continuing pressure on operating results across every asset class. While the hospitality and residential markets may have bottomed out, neither will start improving significantly anytime soon. Many assets will continue to be challenged by declining occupancy rates and property values, debt maturity issues and credit restrictions. New construction projects are expected to be few and far between. As the economic recovery begins to gain hold, much of real estate's revival will depend on the pace and strength of job growth. Some opportunistic buyers and realistic sellers will complete deals in 2010 that could prove to be very positive for investors. Realistically, however, it will be 2011 or 2012 before the United States sees significant increases in real estate value and a corresponding uptick in the industry as a whole.

### Contacts

**For more information, please contact:**

**Robert T. O'Brien**

U.S. Real Estate Leader  
Deloitte & Touche LLP  
robrien@deloitte.com

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