GLOBAL INVESTMENTS IN REAL ESTATE: TRENDS, OPPORTUNITIES AND NEW FRONTIERS

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SUBTOPIC:

"HOT TOPICS IN COOL TIMES: THE U.S. PERSPECTIVE"

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QUESTIONS TO BE DISCUSSED:

1. **How have the real estate investment and development markets changed in the United States in the wake of the financial crisis?**

2. **Has the increased use of receiverships affected the distressed properties market in the United States?**

3. **What types of transactions are being entered into by the FDIC with respect to the assets of failed banks in the United States, and how has this affected the distressed property markets in the United States?**

4. **How has the financial crisis impacted United States commercial real estate investment activity by foreign investors?**

1. HOW HAVE THE REAL ESTATE INVESTMENT AND DEVELOPMENT MARKETS CHANGED IN THE UNITED STATES IN THE WAKE OF THE FINANCIAL CRISIS?

a. With respect to development, 2008, 2009 and the first quarter of 2010 have been punctuated by a virtual cessation of "new deal" activity.

b. While some existing, funded deals have continued or gone forward, newly conceived, newly funded ground up development has been at a virtual stand-still.

c. Here are 2 examples from my home town, Atlanta, Georgia:

i. My Firm's offices are in the Midtown submarket of Atlanta, GA, in a 139 acre mixed-use development that has been open for about 6 to 7 years and is about 40% developed. There are 3 office towers that are 400,000 to 500,000 RSF each. The 1st tower is 95%+ leased. The 2nd and 3rd towers are between 35% and 50% leased. Only one new office lease has been signed in the last 16 months.

ii. In the Buckhead submarket of Atlanta there are 5 new office towers that are all in the 500,000 RSF+/- range, which delivered at different times over a 30-month period ending in the last quarter of ’09. The last of these buildings to start was allowed to go forward and come out of the ground in early 2008 because the owners and lender decided that it was “**now or never**.” They say that hindsight is 20/20, but perhaps “**never**” might have been a better idea, since historical absorption in the submarket is about 300,000 RSF/year in “**good times**.”

iii. These are examples of properties and submarkets that looked great when plans were being drawn up in 2005, 2006 and 2007, and that are now beset with challenges since the world changed in the wake of the global financial crisis.

iv. The development of office buildings, apartments, condominiums and shopping centers has been affected similarly in most major U.S. markets.

d. In this kind of environment, and given the dearth of lending activity, it should not be a big surprise to anyone that speculative development activity is virtually non-existent.

e. But, the general perception is that things are better now, in April 2010, than they were a year ago in April 2009. However, “better” is a relative term. If your measuring stick to assess 2010 is 2009, things are a bit better and seem to be heading in the right direction. If your measuring stick for 2010 is any year in the 2004-2007 range, then we have a long, long way to go.

1. HAS THE INCREASED USE OF RECEIVERSHIPS AFFECTED THE DISTRESSED PROPERTIES MARKET IN THE UNITED STATES?

a. Although lenders' remedies vary on a state-by-state basis in the United States to some degree, in many states, including my home state of Georgia, receiverships are an optional remedy in most loan documents, with the real estate security instrument of choice here being called a "deed to secure debt" which is functionally equivalent to a "mortgage."

b. Receiverships are creatures of statute in Georgia, and are in reality an equitable, litigation-based remedy in which certain basic statutory rules and requirements apply.

c. Under these general requirements there is, however, a fairly wide degree of latitude with respect to things like how the receiver is selected and appointed; what the bonding requirements are for the receiver; what the reporting requirements are for the receiver; and certain other procedural elements of setting up, conducting and managing a receivership.

d. As a remedy, over the last 25 years (and including both the S&L crisis in the late 1980s and the RTC era in the early 1990s), until the last 2 years we saw receiverships used as a tool by lenders very, very infrequently. In part, the rarity of this remedy was based on the simplicity and speed of of non-judicial foreclosure actions in Georgia. Different states, and particularly those like New Jersey or New York where judicial foreclosure is required and can take a year or more to complete, may have historically experienced a higher use of receiverships. When receiverships were used in Georgia in the past, the circumstances were dire and usually involved outright fraud or waste of the property by the borrower. In the last 2 years we have been involved in 15 - 20 receivership actions on behalf of clients, some of whom were the lenders, some of whom were the receivers, and some of whom were the borrowers. We believe that there will be quite a few more of these proceedings in 2010/2011, notwithstanding the fact that Georgia has a very expedited non-judicial foreclosure remedy that is decidedly pro-lender.

e. Why are receiverships so common now, when they were such a rarity for the last 25 years? There are several answers or causes:

   i. Very low property valuations: lenders don’t want to take back REO properties and recognize a loss on a current basis, if they can avoid it. Since lenders themselves have capitalization problems, they can’t afford to devalue their own balance sheets by taking back multiple properties that are now worth a fraction of the original loan amount.

i. Borrowers are willing to "cooperate" in a "friendly receivership" because it gives them some breathing room and a chance to "live and fight another day" if and when property values recover in a year or two.

ii. For the lender, if you can get control of the cash flow and put a "friendly receiver" in place, then you get the chance to "have your cake and eat it too", because you can always commence the foreclosure action at a later date and terminate the receivership concurrently with the foreclosure of the property.

f. The rise in the use of receiverships and the corresponding decline in foreclosures has materially slowed the flow of distressed and foreclosed properties into the real estate markets in the U.S. As a result, some pundits believe that most U.S commercial real estate markets are still struggling to "hit bottom" and begin the recovery in earnest, while others view this as a "soft landing". Regardless of how it is characterized, the rise in the use of receivership remedy has diminished the kinds of opportunistic buying that occurred in the RTC era in the U.S. in the early 1990s, much to the chagrin of the vulture funds that are awaiting such opportunities. As a consequence, the few properties that do come to market that have any good characteristics appear to be benefitting from a "scarcity premium", because there are a lot of buyers with "dry powder" trying to place the equity and debt that they have pooled and are ready to deploy. As a result, any decent properties receive a lot of buyer attention and get bid up in the process.

g. Even if receiverships or their equivalent are not an available remedy in your home jurisdiction you can achieve a functionally similar result by using a forbearance agreement negotiated with the borrower. We have also experienced an upswing in the use of this tool over the last 2 years in lieu of foreclosure. Using a forbearance agreement in lieu of current foreclosure proceedings, the lender can do the following:

  i. Get control of property cash flow.

  ii. Remove and replace existing managing and/or leasing agents with lender-selected vendors for such services.

  iii. Extract stipulations and/or admissions regarding the current borrower defaults (e.g. existence of listed defaults; balances owed for principal, interest, costs, expenses and attorneys’ fees; acknowledgement of receipt of required default notices; acknowledgement of expiration of applicable cure periods; consents to personal jurisdiction and venue; waivers of counter-claims and defenses, etc.).

  iv. Extract comparable stipulations and/or admissions from any guarantors.

  v. If permitted, craft and sign a consent judgment with a pre-approved form of court order that can be filed in court if the borrower violates the forbearance agreement.

3. WHAT TYPES OF TRANSACTIONS ARE BEING ENTERED INTO BY THE FDIC WITH RESPECT TO THE ASSETS OF FAILED BANKS IN THE U.S., AND HOW HAS THIS AFFECTED THE DISTRESSED PROPERTY MARKETS IN THE U.S.?

a. In the early 1990s both the Resolution Trust Corporation ("RTC") and the Federal Deposit Insurance Corporation ("FDIC") began to utilize what they refer to as "equity partnerships" in which they retained a residual interest in sold assets as a limited partner and they provided leverage for the acquisition of the asset by the acquiring equity partnership. The goal of such equity partnerships was to participate through passive equity interests in any extraordinary gains that might be realized by the orderly disposition of the assets at a later time.

b. The use of such equity partnerships as a disposition vehicle for the assets of failed banks had several advantages to an outright sale with no retained residual interest:

   i. Internal FDIC staffing constraints have traditionally hampered the disposition of the non-performing assets of failed banks through normal means.

   ii. Large asset management contracting programs have proven to be difficult to use and arrange.

ii. Use of the equity partnership helped to achieve the goal of not selling at the bottom of the market.

iii. The use of equity partnerships allowed the RTC and FDIC to obtain higher recoveries over time.

c. Although various types of equity partnership structures have been utilized, they typically share certain common features that are designed to align the financial interests of the private sector general partner and the public sector limited partner.

i. Proceeds from the ultimate disposition of the underlying partnership assets are typically distributed pro rata to both parties based on their respective ownership percentages.

ii. The general partner is required to acquire its interest in the equity partnership for cash. The FDIC’s or RTC’s contribution is the share of the assets conveyed to the equity partnership.

iii. The assets are typically “sold” to the equity partnership on a competitive bidding basis, and generally consist of a pool of loans and/or REO properties being transferred on an “all or nothing” basis. This minimizes “cherry-picking” of the better assets and increases transaction size and volume.

iv. The representations and warranties of the public sector limited partner as “seller” are very limited. The sale is basically on an “AS IS, WHERE IS, WITH ALL FAULTS” basis.

v. Various self-dealing and/or affiliate transactions by the private sector general partner are typically prohibited unless preapproved by the public sector limited partner.

vi. The general partner is delegated full responsibility to manage the day-to-day affairs of the equity partnership, including for example managing, leasing, servicing and disposing of assets in the portfolio of assets acquired by the equity partnership. Subcontracting of various functions is typically permitted on an arms-length basis.

vii. The general partner is required to contract with an external independent accounting firm to perform an annual audit and certify the equity partnership’s financial statements.

viii. The partnership agreement provides for the reimbursement of certain general partner expenses incurred on behalf of the partnership, but with actual reimbursement contingent upon the general partner’s compliance with the partnership’s policies and requirements.

ix. The partnership agreement gives the general partner the right to transfer its interest upon approval by the limited partner, but the limited partner can transfer its interest in the partnership without the general partner's consent.

x. The limited partner has the right to remove the general partner for cause upon the breach of certain covenants or if certain conditions occur.

d. A recent example of this kind of transaction is the Starwood Capital/FDIC partnership formed in connection with FDIC auction of a 40% stake in a $4.5 billion pool of former Corus Bank loans on 102 commercial and multi-family properties, mostly condo and apartment complexes. The winning bidder was Starwood Capital. Key transaction characteristics included the following:

i. The transaction valued the assets at $2.77 billion, or 61 cents on the dollar.

ii. The FDIC provided significant debt financing to its new partnership with Starwood.

iii. The agency also agreed to provide up to $1 billion in additional capital to finish incomplete projects.

iv. The structure of the deal gives operating partner Starwood an incentive to hold most of the assets for several years, rather than liquidate right away, much to the dismay of eager high-yield investors who hoped for a “fire sale”.

v. Many Corus loans financed projects in Florida, Las Vegas and Chicago; all of which are now markets with a glut of unsold condos. Unsold and unfinished projects that have come up for sale in such markets have been valued at very deep discounts by bidders. But, with construction in such markets now at a virtual standstill, and with no new projects coming out of the ground, the Starwood/FDIC partnership could emerge as a leading seller of new condos in those markets when demand rebounds. Since this could take a few years to realize, the structure of the partnership, which permits and encourages the slower liquidation of assets, may result in sales over time at materially higher prices, under what are then-current more normal market conditions, rather than permitting or requiring or encouraging a current dumping of the properties into the current condo market at highly discounted prices.

4. HOW HAS THE FINANCIAL CRISIS IMPACTED UNITED STATES COMMERCIAL REAL ESTATE INVESTMENT ACTIVITY BY FOREIGN INVESTORS?

a. Looking backwards: What were foreign investors thinking pre-2009?

b. The Association of Foreign Investors in Real Estate (“A.F.I.R.E”) is a trade association comprised of over 200 members who are major non-U.S. real estate investors who invest in U.S. commercial real estate. A.F.I.R.E. has conducted annual year-end surveys of it members for the last 18 years to determine trends. A look at the headings of the annual year-end surveys over the past 6 years before 2009 tells the story of historical investment trends by foreign investors:

2003: “Drive on for U.S. Real Estate”

2004: “Foreign Investors Will Reduce U.S. Real Estate Portfolio Acquisitions”

2005: “Foreign Investors Trend Toward Global Diversification – U.S. Real Estate Seen as Safe Haven”

2006: “International Real Estate Investors Up Risk Factors (to get into U.S. market)”

2007: "Among Foreign Investors, U.S. Real Estate Trounces Competition, But Gap between U.S. and Asia Narrows"

2008: "Substantial Up-Tick in Foreign Real Estate Investment Expected in 2009. Strong Signals for U.S."

b. For 2009, the heading of A.F.I.R.E.'s annual year-end survey was, "Foreign Investors Pledge Allegiance to U.S. Real Estate", which indicated a strong desire to invest in U.S. commercial real estate in 2010.

c. What was 2009 like for A.F.I.R.E. members?

2009 was characterized by a lack of opportunities and transactions, both in the U.S. and globally.

i. According to a recent 4th Quarter '09 survey by A.F.I.R.E., in 2009 A.F.I.R.E. members placed only 62% of their planned debt placements globally and only 43% of their planned global equity placements; in the U.S. they placed only 35% of their planned debt placements and only 23% of their planned equity placements.

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ii. A.F.I.R.E. respondents in mid-year ’09 said they expected the recovery by or before 2nd quarter ’10; now, half say that they expect the recovery by or before the 4th quarter of 2010.

d. What is in store for 2010/2011?

The U.S. is currently viewed by A.F.I.R.E. respondents as the country providing the best opportunity for real estate capital appreciation:

i. 51% of A.F.I.R.E. 4th quarter ’09 survey respondents picked the U.S. #1 for capital appreciation opportunity (the U.K. is 2nd at 30%, and China is 3rd at 10%).

ii. For the U.S., this compares to 37% in 2008; 26% in 2007; and 23% in 2006.

iii. The last time A.F.I.R.E. survey respondents were this bullish on anticipated U.S. real estate capital appreciation was 2003, which was preceded by the “Dot-Com” bust and 9/11, both of which resulted in steep declines in property values.

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e. What U.S. cities are foreign investors most interested in?

Among U.S. cities, respondents to A.F.I.R.E.'s 4th quarter '09 survey ranked cities as follows:

1. **Washington, D.C. - 39% of the vote**
2. **New York City - 33% of the vote**
3. **San Francisco - 13% of the vote**
4. **Boston - 8% of the vote**
5. **Los Angeles - 4% of the vote**

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f. What global cities are foreign investors most interested in?

Globally, the “top 5” rankings in such survey responses were as follows in A.F.I.R.E.’s 4th quarter survey:

1. **London - 32% of the vote**
2. **Washington - 23% of the vote**
3. **New York - 19% of the vote**
4. **Paris - 9% of the vote**
5. **Tokyo - 3% of the vote**

g. Do these results mean that such investors won’t consider investments in other U.S. or global cities? Of course not; it only is a statement of preference and of confidence in the listed cities.

h. What property types are foreign investors most interested in?

A.F.I.R.E. 4th quarter ’09 survey respondents ranked property types in the following order of preference:

1. **Multi-family**
2. **Office**
3. **Industrial**
4. **Retail**
5. **Hotel**

This is the 2nd year in a row multi-family was ranked 1st (from 2005-2007 office was ranked first).

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i. What countries are considered to be the most stable and secure real estate investment environments?

In A.F.I.R.E.'s most recent survey the U.S. remains No. 1, but with a declining lead. The top 3 choices were:

1. **U.S. -- 44% of the vote**
2. **Germany -- 21% of the vote**
3. **Canada -- 14% of the vote**

i. Worthy of note: In 2008 and 2007 the U.S. received 53% and 50% of the vote in response to this question. The 2009 annual year-end survey is the 1st time A.F.I.R.E. survey respondents have given the U.S. less than 50% of the vote in the years that this question has been included in their survey.

ii. But, 33% of respondents said they were more optimistic now about the U.S. real estate market than they were in June '09, and 66% said their perspective had not changed.

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j. What factors help make U.S. real estate a “safe(r) bet?”

   i. Viewed as best world-wide opportunity for real estate capital appreciation.

   ii. Transparency of market; market fundamentals; and the sheer size of the U.S. market under-gird investor confidence.

   iii. Retreat to security, quality and fundamentals for some investors have renewed interest in the U.S.

   iv. Access to markets; availability of market information; quality of required expertise; and systemization of processes can add to sense of security and comfort.

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k. What other kinds of transactions are foreign investors considering in the U.S.?

  i. Distressed assets/"REO" properties: So far, a lot of talk but not a whole lot of action

  ii. "Loan to own" via the acquisition of distressed debt; these transactions are happening now

  iii. Joint ventures/strategic alliances: opportunities for new equity to salvage an existing deal; take-over of incomplete projects; these transactions are happening now, sometimes in the form of equity investments and sometimes in the form of mezzanine debt

  iv. Off-market transactions: a "consummation devoutly to be wished . . ."

  v. The acquisition of real estate companies

  vi. Broader geographic diversification

  vii. "GSA" or other governmental assets: a way to stabilize returns over a broad portfolio of real estate investments in different asset classes

viii. Different property types: infrastructure; resorts; senior housing; student housing; R&D facilities; medical office; hospital/clinic facilities

l. What makes for a successful joint venture/strategic alliance between a foreign investor and U.S. partner?

i. JVs allow foreign investor to try to avoid or at least minimize risks from lack of market knowledge of familiarity

ii. U.S. partner with “feet on the street” and “skin in the game”, and a properly documented JV relationship, has correct alignment of vision, interests, goals and rewards with foreign investor

iii. “Promote structure” in a waterfall rewards U.S. partner for reaching targeted results, but only after foreign investor has received a priority return on, and a priority return of, the investor’s “new equity”

iv. U.S. partner can earn usual and customary market fees for required development, management and leasing services

m. Conclusions:

i. 2010/2011 should be great years for foreign investors acquiring U.S. real estate interests, particularly if you give credence to the adage that, “you make money when you buy, not when you sell”.

ii. Barriers to entry into the U.S. markets are few, and are largely self-imposed.

iii. Foreign investors with strong ties to foreign banks that already do business in the U.S. should try to use those relationships to their advantage, although loans are beginning to be available once again, albeit on rationale terms.

iv. Commercial real estate markets are not going to get much worse, and probably have already started getting better, but it will be a gradual process.

v. The time to act is now, before everyone else decides that “now is the time to act”

QUESTIONS?

APPLAUSE!!!