

# THE INSTITUTIONAL REAL ESTATE LETTER

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## NORTH AMERICA

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## Bright Lights, Big City

### Institutional Investors Flock to Top-Tier Markets to Snatch Up Trophy Assets

by Rachel Speirs

*Transaction activity picked up substantially in 2010 as debt markets opened up and the attractive yield offered by the real estate asset class lured both traditional and nontraditional investors to the market. The activity, however, has been concentrated on top-quality core properties located in a few select metros, primarily 24-hour gateway cities with economic fortitude. This flight to quality has produced a spike in prices in these prime markets and a widening pricing divide based on asset quality and location.*

It's big, it's stable and it's income producing. It's core real estate, the workhorse of many institutional property portfolios and — according to recent studies by Real Capital Analytics (RCA) and other sources in the commercial real estate market — it is back in a big way.

"Core is the new black," quips Peter DiCorpo, global COO at CB Richard Ellis Investors. "It's sexy to investors right now. They're looking for income-generating properties, and they're finding good risk-adjusted returns with core."

But it turns out that all core is not created equal. While transaction volume for properties priced at \$25 million and higher soared 126 percent through the first nine months of 2010 compared with the same period in 2009, analysis from RCA highlights a distinct bifurcation in

the marketplace and reveals investors' strong preference for high-quality assets in top-tier markets. Their research found that nearly 32 percent of all transactions through the first seven months of 2010 were specifically the most stabilized assets in a handful of select top-tier markets that includes Boston, Chicago, Los Angeles, New York City, San Francisco and Washington, D.C. In these six major markets, data from the Moody's/REAL Commercial Property Price Index shows that the prices of larger trophy properties have appreciated 23 percent, while the overall index has fallen 2 percent during the past 12 months (see "Commercial Property Price Index — Market Bifurcation," page 14).

The preference for high-quality core assets should carry through 2011, says Sam Chandan, global chief economist and executive vice president of RCA and adjunct professor at the Wharton School of the University of Pennsylvania.

"Not only have we seen improvement in the volume of closed transactions, but also those that are in contract have been strong," he says. "This suggests that as we move into early 2011, the market will further extend its current momentum."

Institutional investors favor core investments today for a number of reasons, according to DiCorpo.

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# Blame the Caddy

## Some Investors Have No Clubs Left in the Bag

Play it as it lies! A fundamental aspect of golf is realizing which club is appropriate for a particular “lie.” The past two decades of real estate investing can be summarized by stating different times (lies) required different approaches (clubs). As we progressed through the 1990s and up until about mid-to late 2007 — except for a post-dot-com lull — there was always a theme, an approach, that would last for a few years and keep real estate values rising. In golfing terminology, there was always another “club in the bag” available to investors.

These days, with seemingly no clubs left to choose from, do investors take responsibility and admit that they got caught up in the mania that consumed the market? Of course not! Well, since there are no clubs left in the bag, let’s blame the caddy! I mean, it has to be somebody’s fault, and it’s certainly not ours!

A look back at recent history helps explain the current situation. In the early 1990s it was relatively simple — just about anything purchased from the RTC or a bank REO department could be sold later for a profit. Then, in the mid-1990s, the REIT market got white hot. Remember when nearly every REIT IPO jumped 20 percent in price on the first day? Easy money was made by those fortunate enough to be allocated pre-IPO shares. Investor appetite for REITs became so great that aggregators of real estate based their business plans on a REIT execution. The REIT market also bailed out many owners of underwater portfolios. In 1990 the total capitalization of the REIT universe was \$8.7 billion. This figure skyrocketed to \$140 billion by 1997 where it hovered until 2002 — then basically doubled to \$330 billion by 2005. After peaking in 2006 at \$438 billion the REIT market has retreated to the \$300 billion level

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***Underwriting standards became so lax that brokers were actually advising sellers not to lease vacant space in properties because the anticipated increases in future rents would produce a higher value today. The same result could be achieved using a putter or a driver — everything worked.***

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where it remains today. For the past two decades, the REIT market was like a long iron — it provided some pretty good distance and didn’t go too far off line.

If the REIT market was a long iron, the CMBS market was a Great Big Bertha Driver — attaining previously unattainable distance. The evolution of real estate CMBS in the 1990s enabled borrowers to access higher leverage than normal. In 1990 CMBS represented only 4 percent of all commercial and mortgage loans issued but rose dramatically to 25 percent by 2005. Investors were led to believe that CMBS, the tool of modern day finance, was too sophisticated to fail. Trillions of dollars were funneled through this new, almost magical process also referred to as conduit lending.

The good times of the 1990s weren’t limited to commercial real estate investors. The Tax Relief Act of 1997 permitted homeowners to pocket up to \$500,000 tax-free profit from the sale of their home. Perhaps

unintentionally, the new law encouraged “flipping” as many homeowners were eager to make a profit and subsequently search for a similar opportunity. Higher leverage, lower interest rates and a lack of credit standards all contributed to a frenzied atmosphere where buying property was as easy as buying groceries. The subprime market was a perfect example of process run amok and threatening financial stability. Unsound principles and practices were enabled and encouraged by irresponsible politicians and regulators, concerned primarily with enhancing their own immediate objectives.

A popular club in the bag for homeowners was home equity loans — which could be obtained with a mere phone call. The competition became fierce, with lenders making loans at 125 percent of the home’s value. The home equity loan market size quadrupled to more than \$400 billion. When asked about the impact of home equity loans on the economy, Alan Greenspan, then chairman of the Federal Reserve, stated that the Fed, while able to measure the dramatic increase in the aggregate size of the market, had no idea what the proceeds were being used for — except that the money was not being reinvested into the homes that were the source of the loans. Homeowners were effectively using their residences as ATMs, withdrawing the money and spending it. The net effect was that consumers were leveraging up their primary traditional source of wealth — their homes — with the hope that future appreciation would eventually bail them out.

As the new millennium arrived and the dot-com era vanished, CMBS issuance hovered at about \$50 billion annually from 1997–2000 and the REIT window closed. In 2000 the country was in a recession for the first time in nearly a decade. The S&P 500 Index dropped from 1,500 all the

way down to 800 by mid-2002. The NASDAQ Composite Index experienced an even more precipitous decline, falling from 4,700 down to 1,330. The effect on investment portfolios was disastrous. The mantra for several years had been that investors needed to invest for the long run — and having a majority of their portfolios in equities was the smart and rational investment strategy.

During the recession, Greenspan and the Federal Reserve continued to attempt to stimulate the economy by infusing massive amounts of liquidity into the system and bailing out firms such as Long Term Capital Management. Unknowingly, his actions gave the financial community an even larger sense of entitlement than normal and set the stage for a prolonged period of reckless and unconscionable lending practices. There were no consequences for lax underwriting standards and poor decisions. Major lenders and the politicians they purchased were complicit in pushing the financial system to the brink of collapse.

The calamity that engulfed the equities markets turned out to be fortuitous for real estate investors — both commercial and single family. Investors, already reeling from losses in the stock market, could not find comfort in the bond market as rates moved lower. Real estate, which had been in the doldrums for a few years, began to look attractive again compared to alternatives. Two of the last remaining clubs in the bag, interest rates and leverage, became a real estate dealmaker's dream. As interest rates fell, real estate capitalization rates followed. A property with no change in net income was suddenly worth 30 percent more due solely to the change in cap rates. Conventional debt underwriting levels were cast off, and it became common to see leverage in excess of 80–85 percent. A rejuvenated CMBS market pushed real estate prices higher and to the point that initial cash yields were reduced to below 5 percent. Underwriting standards became so lax that brokers were actually advising sellers not to lease vacant space in properties because the anticipated increases in future rents would produce a higher value today. The same result could be achieved using a putter or a driver — everything worked.

This period also produced exorbitant fees for a number of fund sponsors in the real estate investing universe — at the expense of the investor. For the largest investment funds, raising a billion dollars barely

HLTs (highly levered transactions), dividend recapitalizations and other techniques executed by the “smart” money came crashing down in late 2007.

Financial institutions are holding trillions of dollars of impaired loans not indicative of their true value. The solution is to allow the market to correct — to let the “creative destruction” process determine the outcome. If not, it may be years before real estate fully recovers. The market is currently sending a message in today's low interest rate environment where banks won't lend — and it's not optimistic. Perhaps the only remaining option is the “rescue” club. Like the infamous scene from the movie *Tim Cup*, blaming the caddy might feel good temporarily, but ultimately the golfer is responsible for choosing the club and living with the result. A lot of real estate investing shots have been hit into the hazard and are underwater but not yet reflected accurately on the scorecard. ♦

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made the news. The mega funds had to deploy their newly raised capital in order to maximize the fee streams for their sponsors. The mammoth funds encouraged equally sized risk taking, producing transactions of historic size such as the \$39 billion Equity Office Properties Trust deal in 2007. Preservation of capital became so passé, and real estate became the new dot-com.

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