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Carpathia Real Estate Advisors LLC

## *Heading for a Slow Recovery: In this Market, Nothing Good Comes Easy*

By Mark Antoncic

October 2010

Although the process seems painfully slow, commercial real estate markets have begun to stabilize and potential investment opportunities begin to present themselves.

- Long sidelined capital chases after the handful of premium properties coming to market and just about anything in the multifamily sector
- In measured steps, the FDIC sells off troubled assets from myriad shuttered local and regional banks across the country
- With regulators' support, lenders continue to give many struggling borrowers a break, but show signs of finally moving in the direction of clearing balance sheets of hundreds of billions in distressed assets, a precursor to making new loans
- Life insurance companies, meanwhile, have reentered the mortgage markets, targeting core properties and even considering apartment development deals
- Most tellingly, CMBS issuance resumes albeit at a small fraction of the vastly overblown 2007 market peak.

This faint, but definite progress in the commercial property sector occurs against the backdrop of a struggling U.S. economy, which gains little traction for creating enough jobs to accelerate a more robust recovery. A combination of technology driven productivity gains and competition from lower cost global markets suppresses domestic hiring. Overleveraged consumers, hamstrung by depressed housing values and concerned by high unemployment as well as stagnant incomes, necessarily curtail spending. An economy, which grew for decades off ample cheap credit, now must climb out of its giant debt hole.

Consequently, a new more austere paradigm of paying off bills and saving for future needs won't light a fire under the real estate markets, especially with another trillion plus dollars in maturing debt coming due for refinancing over the next four years.

And that's the problem facing property investors as markets now lurch off bottom. Demand fundamentals likely will stay weak for the foreseeable future in most sectors, chilling rent growth and damping the chance for significant appreciation. We believe that there will be no sudden pricing spike—write downs have only been delayed, not avoided. Investors in many late-in-cycle opportunity funds have lost their equity stakes with diminishing chances of recouping much value even with lender

forbearance. Banks and CMBS bondholders come to realize they must absorb significant losses and move on.

So what does moving on look like in a slow growth environment?

### **Deleveraging**

We believe that for the next several years, borrowers and lenders will continue to modify and extend loans at lower bases with earn-out provisions and hope notes. Increasingly, borrowers will bail on lost cause investments, refusing to put more equity in, and lenders will move properties off balance sheets. The art of the workout for both sides will be to maximize value wherever possible, while working off the burdensome debt load. Unfortunately for lenders, buying time and waiting for an improving economy to restore values won't pan out for many assets backing the glut of problem loans.

### **Buying core**

Cash rich investors have been buying a relative handful of core properties at increasingly pricey levels. If they can finance at 50% to 60% loan to value at current record low interest rates, then most likely they can lock in future value when rates inevitably increase. These are back-to-the-future acquisitions where investors must be satisfied with stable income returns and the chance for modest appreciation over longer term holds.

### **Acquiring Distress**

Opportunity investors have been frustrated over the dearth of distressed sales. Patience can still be rewarded— there's plenty of time ahead for lenders and government regulators to disgorge what will be mounting real estate owned (REO) portfolios and to recapitalize teetering borrowers unable to refinance maturing loans. Investors need to target loan to own opportunities in good quality assets mired on bad balance sheets, and avoid B minus and C properties in off locations, potentially marginalized by obsolescence. We believe that many of these lesser-grade properties will be bulldozed, redeveloped and refashioned into new uses, or gather dust.

### **Buying Loan Pools**

Based on the current market outlook here investors will need to exercise extreme care. FDIC sales and eventual bank dispositions will contain a flood of beaten up assets with weak to zero prospects— roadway motels, fringe strip shopping centers, busted condos, c-grade suburban office, and land parcels in the middle of nowhere. For every golden asset in these pools, there may be five to ten stinkers. Given the problematic economy, vulnerable assets may not have a chance to recover quickly enough to justify the investment risk even at cents on the dollar. And with the blessing of government regulators, banks are in no hurry to give away properties at fire sale prices. The jury is still out on whether buyers will be able to reap RTC-style rewards, and under any circumstances they will need to be prepared to undertake complicated workouts and intensive asset and property management for far flung holdings, a time and manpower intensive enterprise.

### **Refinancing**

We believe that hundreds of billions of dollars in maturing loans will need to be refinanced annually over the next five years, offering lenders the opportunity to secure excellent risk adjusted returns

recapitalizing owners of core and core plus assets at realistic value levels (down 30% to 40% off peaks) near market bottom. Banks and conduits will eventually re-enter the lending markets, but a financing gap will remain for at least the next year or two, which savvy investors can fill. They must underwrite carefully and rationally, anticipating slow growth.

### **Adjusting Expectations**

The problematic U.S. economy should give pause to anyone thinking that real estate markets can recapture what proved totally unsustainable—20% plus returns, except on well-timed one off deals. We track and advise on real estate portfolios across the world. Whether in Asia, Europe or in North America we see economies struggle to gain traction and cope with worldwide deleveraging. The days of outsized real estate performance—the rapid appreciation driven by cap rate compression and fueled by ample cheap credit—are over and lackluster U.S. jobs creation and compensation trends should further sober investors across all asset categories, including stocks and bonds. But solid risk-adjusted real estate performance in the low double digits is readily attainable through comprehensive strategies which encompass tactical buying and well-constructed asset management programs over longer holding periods.

We most definitely believe that we're moving through a phase of recognizing legacy losses and reorienting to a new market cycle-- offering investors the chance to make up ground gradually in an elongated recovery dictated by a plodding economy. In this market, nothing good will come easy or quickly.

### **About the Author**

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Mr. Antoncic is the Managing Partner of TriLyn LLC, a boutique asset management and investment firm that serves as both a principal and an advisor for debt-oriented real estate investments. In addition, he is a Managing Member of Carpathia Real Estate Advisors LLC, a joint venture between TriLyn and The Tuckerman Group/State Street Global Advisors. Carpathia provides institutional clients strategic services for managing real estate equity and debt portfolios, seeking to protect and maximize value in today's demanding markets. Mr. Antoncic has over 25 years of real estate and capital market experience.

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