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Trends in US real estate finance could spill over into European markets

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Time and again commercial real estate trends in the United States spill over into the European markets, and the latest such trends have formed, and are still forming, as an outgrowth of the current economic recession. The following are two US trends that have emerged which could present opportunities for European investors.

Trend 1: Recapitalising existing real estate ownership entities to pay down debt. A product of the current economic crisis is dislocation in debt markets. In contrast to the large number of US commercial mortgage originations in 2006 and 2007, originations in 2008 and year to date 2009 saw a significant decline. Commercial property values have dropped by as much as 50% due to deteriorating real estate fundamentals and a cautious lending environment. Values likely won't recover in time to allow for mortgage refinancings or extensions upon maturity at current principal balances. This problem appears to be magnified for loans made during the height of the recent bubble. High leverage was utilised to chase ever-rising valuations. With over \$500bn of debt maturing over the next three years, much of it originated during 2005-2007 - resulting in covenant violations requiring deleveraging - more owners and investors will be waiting in line for capital. If you examine the three prime sources of commercial real estate lending - commercial banks, CMBS and insurance companies - you won't find a whole lot of hope, or money. Though the demand for liquidity has become acute, the supply of capital remains scarce, opening the door for secondary market investors to assist owners in recapitalising positions. To satisfy de-

leveraging requirements, many owners opt to recapitalise equity positions on assets to pay down debt. Although selling stakes to repay loans has traditionally not been a popular route due to the higher cost of equity capital, it has been the more attractive option for sponsors seeking to maintain ownership and operational control while avoiding property being seized by lenders. This trend has gained considerable traction in recent months in the US, and we are bound to see more of this in Europe as more high-leverage debt matures in the coming years, creating opportunities for investors with capital to deploy in the secondary market.

Trend 2: Institutional joint venture partners seeking exits. Another result of the current crisis is the trend toward institutional net capital outflows from commercial real estate. Many capital partners have been and continue to seek an early exit from their joint venture or partial interests. However, prevailing bid-ask spreads and diminished liquidity in the debt and equity markets have halted traditional asset sales, resulting in limited options for owners and investors wishing to monetise illiquid real estate positions. General partners are increasingly unwilling to accommodate limited partner requests to sell within the above framework, leaving many capital partners exposed to imbalanced portfolios - due to declining valuations in non-real estate assets - and situations where capital calls outpace distributions. This phenomenon has existed in the US for several years. Majority ownership positions in Class A quality assets will likely remain the first to trade, but owners of minority positions find the market for their holdings far less robust, due to

the non-controlling nature of these investments. As institutions continue to reallocate their portfolios, secondary market investors are in a unique position to take advantage of the opportunities that arise from this need for liquidity.

As these trends materialise in Europe, opportunities in the secondary market will abound for well-capitalised investors. However, as in the primary markets, a significant bid-ask spread remains in the secondary market, making it difficult to transact. The most effective way to close this is via creative investment structuring. Investors open and willing to entertain or engineer structures that veer from the beaten path may find a solution in the interest of all parties involved. Such structures may include a preferred rate of return and preferred return of capital to the incoming investor, and/or a tiered promote structure that gives an incoming investor greater comfort by achieving certain return hurdles while disproportionately rewarding a sponsor for better performance. Underwriting metrics, conservatism and return hurdles differ, and as such a middle ground may be achievable. Once the practices of structured equity and structured debt become commonplace in European markets, we will see more of the demand for liquidity being met and greater volume in the secondary markets. This trend may be slow in coming in Europe. Nonetheless, those who are able to manipulate and master structured investments will have a leg up in closing deals resulting from recessionary trends. ■ rd

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