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How Do You Price a Secondary?

Ronald Dickerman, president of Madison International Realty, answers this month's reader's question: "How do buyers price illiquid joint venture interests held by institutions in the changing economic environment?"

The current economic crisis and distortions in the capital markets have created unique underwriting challenges for pricing interests in the secondary market, resulting in a bid-ask spread that continues to stifle transaction volume. Those requiring liquidity seek certain transaction execution, while active investors cannot ignore a generally bleak outlook for commercial real estate and practice conservatism in their approach. With the necessary attention and accommodations during the underwriting process, however, high-quality assets and sponsors can find a common bid-ask price, and the result will be increased transaction volume.

Pricing is particularly challenging because joint venture and limited partnership interests are inherently illiquid for several reasons; chief among them is the lack of a formalized marketplace and their non-controlling nature. By definition, the lack of a formalized marketplace leaves owners of partial interests in want of more potential buyers. This dearth of bidders at the table results in less competition and often leaves bids well short of the desired ask. Furthermore, investors who have made it to the bidding table must be prepared to surrender their desire for control over the underlying asset in question with regard to management, leasing and investment hold period. These features adversely affect value in a way that current owners are not always prepared to figure into their ask prices, hence a still larger bid-ask spread.

Beyond the inherent illiquid nature of the secondary market, a

Executive Summary

- ◆ **A property's cap rate, expected rate of return and bid-ask spread factor into the final pricing of a secondary deal.**
 - ◆ **Buyers are wise to assess the debt structure and quality of underlying properties before bidding.**
 - ◆ **Sellers can help close the bid-ask spread by offering creative financing and providing as much transparency as possible.**
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confluence of market conditions have aligned to produce a global marketplace where the demand for liquidity is acute, and the supply significantly diminished. The waning tide of the erstwhile boom economy has exposed a treasure trove of new opportunities for well-capitalized investors looking for bargain prices.

Prevailing bid-ask spreads and diminished liquidity in the debt and equity capital markets have halted traditional asset sales, resulting in limited options for owners wishing to monetize their illiquid real estate positions. General partners are increasingly unwilling to accommodate limited partner requests to sell within the above framework, leaving many types of capital partners exposed to both imbalanced portfolios (due to declining valuations in non-real estate assets) and situations where capital calls outpace distributions. Mortgage refinancings, when attainable, often require additional equity infusions, which capital partners might not want to, and in certain cases might not be able

to, effectuate. Add to this more than \$500 billion of debt coming due in the next three years — much of it originated between 2005 and 2007 — and the result is covenant violations requiring deleveraging, which means 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. These scenarios create a situation where current owners, eager to divest or recapitalize their positions, find it difficult to swallow the bargain-basement bids presented by the marketplace.

UNDERWRITING METRICS AND RISKS

Active investors in today's market are much more meticulous and thorough in their due diligence process than they were in the market of yesterday. Gone are the days when a buyer would turn around its due diligence in less than a month in order to gain favor over a competing bid. Oftentimes due diligence will require several months (in some cases the better part of a year) to gain a thorough understanding of and level of comfort for an investment and all that it entails. This process is even more painstaking for investors in the secondary market, given the nuances of such investments, variable pricing dynamics, and oftentimes lack of transparency that must be endured in the purchase of these illiquid interests.

The lack of control that comes with purchasing a partial interest in a joint venture or limited partnership requires an incoming investor to obtain a high level of comfort in the competence of the sponsor as well as the existing lease and debt profiles of the underlying assets. Without the ability to make

day-to-day management and leasing decisions, a potential interest buyer must be certain that the properties are in a favorable position to weather the storm, and that those calling the shots have the experience and capability to maintain the properties' strong position through the current market crisis. Long-term leases to high-credit tenants and well-experienced, highly respected sponsors become a prerequisite for many potential investors in the secondary market.

Pricing these illiquid secondary interests and, perhaps more relevant, negotiating a price become additional hurdles to overcome when multiple parties are involved. Because many of the recapitalizations taking place in the secondary market are a result of debt covenant violations and deleveraging requirements, the dynamic presented by lenders moves to the forefront of pricing considerations. Once those first in line for much-needed liquidity have been placated, a structure must be agreed upon that is satisfactory to all parties involved. Oftentimes, creative structuring can facilitate a solution to the omnipresent bid-ask pricing challenge.

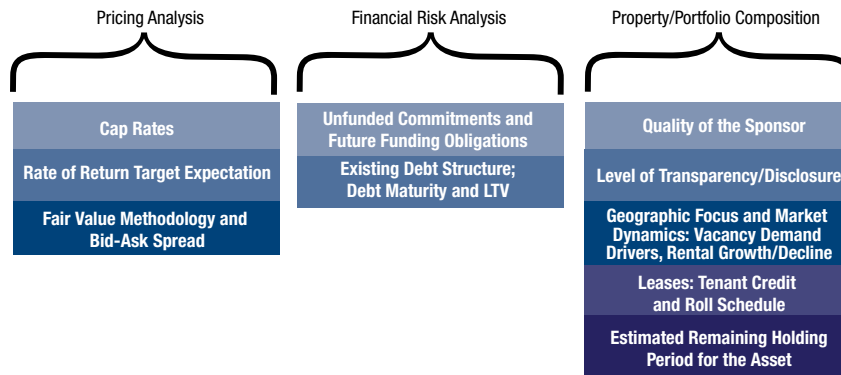
Frequently with opportunities in the secondary market, there exists a lack of transparency with regard to the background of the investment, investment structure, condition and performance of the assets, as well as third-party appraisals and market assessments. This creates the need for extensive market research and even greater measures for conservatism.

Other factors instrumental in the underwriting process for secondary interests include: lease expiration schedule; debt structure with regard to maturity, leverage ratio and covenants; cash on hand for leasing and capital improvement requirements; asset quality, condition and location; historical performance; and the relationship with the sponsor and potential for follow-on investment opportunities (see chart, top right).

CLOSING THE BID-ASK SPREAD

Secondary investors' primary goal during the underwriting process is to attain a level of comfort and confidence in their valuation by applying appropriate conservatism and

Secondary Real Estate Interest Factors



Source: Madison International Realty

achieving their return hurdles, while at the same time producing an offer that is attractive enough to the counterparty to close on the transaction. In order to facilitate this goal, sellers of the partial interest have a few tools in their arsenal. A seller should: 1) provide an investor with comfort in the underlying property, its operations and the quality of the sponsor; 2) be open to creative structuring solutions that have the ability of satisfying the parties; and 3) provide as much transparency as possible.

Investors in the secondary market typically expect to surrender any hope for control over an investment, so if a seller can provide comfort on various issues, the impact on pricing can be eased. Buyers can be picky and are typically interested in the best properties, so if at all possible, a seller should start with a good underlying property to offer with favorable lease and debt profiles. Properties with strong operating histories and sponsors with extensive experience in the market will show well in the eye of an investor. To the extent that partial-interest sellers will remain in an investment and are able to relinquish some control variables that consistently factor into pricing considerations, this is an excellent way of providing comfort for an incoming investor in the secondary market. Such variables may include major leasing and property management decisions, balance sheet and financing decisions, and disposition and hold period judgments.

Another very helpful tool in closing the ubiquitous bid-ask spread

is creative investment structuring. Owners who are open and willing to entertain or engineer structures that veer from the beaten path may find a solution that is in the interest of all parties involved. Such structures may include offering a preferred rate of return and preferred return on capital to an incoming investor, 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. Everyone's underwriting metrics, conservatism and return hurdles differ, and as such a middle ground may be right around the corner.

The more transparent a seller can be, the easier a potential buyer may find it to justify a higher price. When an investor is able to achieve a greater degree of certainty in a transaction, more risk falls by the wayside, as does the need for greater conservatism in the underwriting. Some of the provisions that provide a clearer picture for an investor include: background of the investment and existing investment structure; full disclosure on the condition and performance of the assets, including third-party reports; third-party appraisals; and comprehensive local market research from reputable sources. ❖

Ronald Dickerman is president of **Madison International Realty**. The company acquires existing real estate joint venture, limited partner and co-investment interests as a principal in privately negotiated secondary transactions on behalf of its managed private equity funds.