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Opportunity from the Ashes of a Real Estate Meltdown

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In science we learned that for every action there is an equal but opposite reaction. In the social sciences and in society generally that may not be precisely the case. From a threshold level, one might be tempted to believe that in the destruction of the real estate and capital markets, the general rule would have applied. As losses are being absorbed by a wide variety of real estate industry players and along a surprisingly extended time line, the "shock effect" has been somewhat muted, new opportunities are created and mere survival becomes tentative growth.

A closer analysis reveals that, in fact, the "second great depression" has certainly caused an opposite, if not equal reaction in property underwriting and development, that has resulted, and continues to result, in new foundations upon which a vibrant property market may be built. This is not to suggest that we are past the effects of the real estate recession, as the continuing global recession and the generally weak US economy serves to place limits on the possible. However there are real estate needs that must be met – and there are funds available for that purpose.

THE MONEY - WHO HAS IT AND WHERE WILL IT BE DEPLOYED?

One natural reaction to the real estate recession is the rise of the Opportunity Fund. For those who remembered the lesson of the last real estate recession, where the Resolution Trust Corporation sold real estate owned and real estate loans of failed banks at pennies on the dollar, the desire to replicate that situation by any potential investor with cash on hand or accessible was huge. While financial institutions were not lending, as they dealt with their own crises, the cash was there to pick up the pieces and the potential ensuing profits. Initially the expectation was that the United States government, through the FDIC or otherwise, would want to take over failing institutions or their assets, or both, and recover as much as possible, as quickly as possible – with a fire sale of the assets being the rule, rather than the exception. But the lessons of the last recession meant that the government would enter into a no "give away" programme – this time, it would share in the potential upside of the battered real estate investments. Thus was borne the FDIC loss sharing programme, where the FDIC would share losses with financial institutions who acquired the real estate assets of failed institutions, and the FDIC asset sale programme, where the FDIC would put a pool of assets

out to bid and expect a guarantied purchase price (which may or may not be financed by the FDIC), as well as a participation feature tied to performance of the assets in the pool.

As a result of the FDIC's thoughtful approach, the engagement of sophisticated financial advisors, and the requirements that it placed on "eligible bidders" many smaller opportunity private equity funds were eliminated from participating in the process, but there was no lack of bidders for the various assets. More recently the smaller funds have ventured with bigger qualified bidders to get in the FDIC game, while pursuing individualised acquisitions of financial institution owned assets outside of the stringent requirements of the FDIC. For example, one client of our firm (a MWOB – minority and women owned business) teamed with a multi-billion dollar company to acquire a note secured by a sizeable medical office complex in North Carolina directly from a bank that opted not to struggle with exercising remedies. For institutions that survive, but have written down or reserved against depressed real estate investments on their books, or both, the opportunity to sell the assets and reclaim capital is enticing.

The hunger for these investment opportunities can, naturally, lead to acquisitions at inflated prices, be it for a single asset or a pool of assets. Professional due diligence and appraisals can minimise any potential loss, as can and will a rising real estate valuation market, as an investor, even if it overpaid, may not need to wait very long to be in a positive situation. Certain asset classes may be preferred to others, serving to drive up the price paid for loans secured by multifamily properties, hotels and even finished housing lots, as well as the properties themselves if owned by the financial institution – all to the benefit of the financial institution. Despite the almost insatiable hunger for transactions, one common thread is a return to fundamentals. As much as investors may (or should) be willing to pay more, the deals must make sense to the investor and any prospective lender. Exit strategies (which more often than prior to the real estate recession are "long term hold" strategies) are now commonly "stressed" against dire economic scenarios to test the integrity of the investment.

THE RETURN OF THE HOME OWNERSHIP MARKET?

While many professional prognosticators believe that residential construction and home sales is the key to ending the negative real estate impact of the recession, and, indeed, curing what ails the economy, that may only be one possible scenario. In historically overheated markets, many families worry about how their children will ever be able to afford to buy a house. Certainly this will put downward pressure on prices, especially with bank foreclosures continuing to be brought to the market. But at the lower end of the markets where prices rose dramatically for many years, there is a great deal of activity and interest, as many condominiums and single family residences attract multiple offers. So even today there is pent up demand for home ownership, and that demand is likely to increase in the future, along with the pent up demand for move up housing opportunities – mirroring what happened as the last recession abated.

However, as with investment in general, for home builders, the new focus on "fundamentals" means that not all investment opportunities will be viewed the same. Housing in many urban areas has and will stabilise and recover more quickly, while suburban housing is likely to languish until more creative development with smaller lots, fewer amenities and lower pricing meets the financial capability of new home buyers. Condominium projects in the selling mode when the recession hit, while converted to a rental project in the short term, will again find footing in the new urban market of for-sale housing as the market dictates, while smaller urban infill projects with housing elements will continue to flourish. This "return to the city" shift in residential patterns, which actually started prior to the recession, to some extent reverses years of suburban tract housing development focus. Ultimately this will affect the demographics of inner cities and the infrastructure needs of those cities for years to come. Already, politicians and planners have begun to understand the implications of

this change and the opportunity presented to reshape mass transit, renewable energy and other areas not previously addressed.

But the need for affordable housing means that ultimately the outlying suburban areas will not be ignored for long. As the market absorbs existing single family residences, new housing becomes attractive to the nations' homebuilders. When the real estate market crashed, the homebuilders were "stuck" with finished lots, unfinished lots and unentitled land tracts with no market in sight. Almost all had negative land value and such properties were marketed for whatever price might be available. Then, it took a very long term perspective to even contemplate being a buyer, even at bargain prices. But those who did buy are being rewarded today, as those same homebuilders, who have had ample time to gauge the market and prepare for what will sell and at what price point, are back in the market for development product to meet expected demand.

THE LIGHT SHINES ON MULTIFAMILY

The equal but opposite reaction to the home ownership slump has been the emergence of the attractiveness of multifamily property acquisition and even development. As foreclosures have forced homeowners from their homes, the former homeowners and their families have either moved in with relatives or sought out reasonably priced rental housing. The result has been an increase in rents, increasing valuations and bid prices meeting owner's ask expectations. Traditional lenders in addition to Fannie Mae and Freddie Mac have continued the loan flow into multifamily acquisitions and refinancing.

On the construction side, there has remained some considerable interest in affordable housing projects and student housing opportunities. Market rate rental housing construction has for the most part been, and may continue to be, financed through one several loan guaranty programmes through the Department of Housing and Urban Development. Recently this firm worked with the developer of the Shores project in Marina del Rey, California – a 544 unit (57 affordable housing units) construction project on land ground leased from the County of Los Angeles. This complex project qualified for a US$125 million construction and permanent loan under the FHA Section 221 (d)(4) programme – the largest loan of its type guaranteed by HUD in California, if not the entire United States. More recently, as valuations are on the rise, more traditional lenders have expressed interest in financing construction of multifamily projects.

Eventually rentals will rise to the point where it will make economic sense for renters to re-enter the home ownership market, particularly in the condominium market as noted above. Nothing would make the homebuilders more pleased; yet this will not necessarily cause a dramatic downturn in the fortunes of rental housing. Much will depend on the type of loan programmes that may be available under the watchful eye of the United States financial institution regulators.

OTHER POTENTIAL BRIGHT SPOTS

As construction activity has receded, the pause has provided local government regulators with an opportunity to take a step back and examine their development entitlement and approval processes in preparation for the next wave of development. In many jurisdictions, the myriad required governmental approvals, environmental impact reports, and all of the development fees to be paid, have resulted in an uncoordinated maze for developers to try to find their way to an end game. One historical result has been challenges from anti-development groups based on technical noncompliance with one requirement or another; whether material or not, this has served to delay development projects to the point where, for many, the financing markets changed and no financing was available. Many municipalities are rethinking their processes to implement a one stop approval process to facilitate development, particularly in those depressed areas of the country in dire need

of development. Although there has been significant attrition among veteran governmental regulators, the expectation is that those in charge will ultimately meet the manpower and process challenges to streamline the development approval process.

Governmental planners also now realise that development planning has the potential to cause a renaissance in the historically industrial cities whose fortunes have declined with the loss of middle class jobs, the flight to the suburbs and the tax advantages offered by the southern states. While it has been painful to view news reports of huge blocks of housing left abandoned in cities like Cleveland and Detroit, the ability to aggregate such properties for well planned public-private partnership redevelopment, can serve to reverse the decades long dénouement of the inner city. While not of the same problematic scale, Los Angeles has been at the forefront of downtown development through building conversions to residential and the influx of new restaurants in some unlikely places that have attracted many middle class and young adults to consider residing downtown. Certainly the development of Staples Center and LA Live has accelerated the process, even during the recession. Hopefully these urban areas will take advantage of the opportunity to create new, vibrant, attractive communities – and accelerate, if not create, flight back into the inner city.

The current economic depression is undoubtedly one of the most challenging economic environments ever encountered. Unlike the Great Depression, however, war time spending and massive governmental projects will not be the solution. Rather, we will need to (painfully) digest our distressed projects, grapple with deficit spending and likely austerity programmes now needed to deleverage, and come to grips with the fact that, fundamentally, our society and economy has changed.

Real estate and real estate development have not been spared from the impact of the sea change we are witnessing. But change is not bad; change is change. As the dust starts to settle, and trends begin to materialise, what is clear is that “this” change may result in an unparalleled revitalisation of urban areas, green development and live-work areas. Investors, both on the equity and debt side of transactions, will need to have “more skin in the game” and will not be able to very easily, if at all, pass the buck while earning big fees. Ironically, what those concerned about over-development, climate change and other environmental issues attempted to accomplish with land use restrictions and sustainability goals may succeed as a result of the break down of financial guidelines and new financial regulations. While this is not the way anyone would have envisioned this to play itself out, it is certainly definitely proof of the old adage that “whatever doesn’t kill you makes you stronger” as new opportunities rise from the ashes of the old.

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