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Among Buyers, Who Will Step Up?

No single buyer group is leading the charge for commercial property in 2010, but REITs look the best poised to make a significant impact, according to a new report from New York-based researcher Real Capital Analytics (RCA). The dearth of transaction activity that began in 2008 and carried through much of 2009 finally began to ease in the third quarter and looks to continue into 2010. However, buyers are minus a lead dog to guide the way. The biggest bellwether appears to be the public REITs, which have already committed to acquire as much property so far in 2010 as they did for all of 2009. They've also raised an enormous amount of dry powder for the job, an estimated \$30 billion. Across the buying landscape, there does seem to be at least one consistent theme – a frustration at the lack of product. This is most evident when quality assets hit the market. They are quickly bid up by the pool of salivating buyers. Among buying groups, foreign investors have yet to create a surge in buying activity. Equity funds targeting distressed assets also have raised enough capital to have a serious impact on the market, but their high return expectations are dampening real activity. According to RCA, prospective investors are increasingly divided between two camps: core and opportunistic, and although they all are looking for bargains, few are finding them. Core buyers complain that there are few suitable, quality assets on the market and competition for those that are available is steep, pushing pricing to surprisingly strong levels. Opportunistic buyers have been denied the expected tsunami of distressed sales and are now realizing RTC-like returns will be unlikely. Some may have to alter their initial investment strategies or lower their return expectations. Just 10.8% of all sales in 2009 were associated with distress, but the composition of those buyers differs from non-distressed sales in some meaningful ways, especially within each property type. Overall, players from all sectors, except the public and private REITs, are active in the distressed space. Surprisingly, institutional investors are buying a significantly greater share of distressed sales than of non-distressed, and foreign buyers have been equally active in both arenas. Equity funds have been buying a slightly greater share of distressed than non-distressed properties. Without decisive moves from REITs, foreign buyers or equity funds, the buyers in the market have largely been private and mostly local. Users, including corporations and governmental and educational entities, have also stepped up to become the second most active buyers of commercial property. As the market recovers, a shift away from private local buyers and users to national and international investors is expected. **(National Real Estate Investor/Ben Johnson)**

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Bad CRE Debt Threatens U.S. Economy, Congressional Panel Concludes

Unless there is a strong and immediate improvement in the U.S. economy, it is likely to receive yet another sucker punch from the \$1.4 trillion in commercial real estate loans coming due over the next three years. That's the conclusion of a 184-page report released by the Congressional Oversight Panel (COP) last week. Of the approximately 8,100 banks in the U.S., 2,988 are small banks that are dangerously exposed to commercial real estate. In addition to the lack of diversification, these community and mid-sized banks also hold high concentrations of the riskiest and least sought-after loans, including transition properties and construction loans in secondary or tertiary markets, according to the panel. "A significant wave of

commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American," the congressional inquiry reported. The COP, established by Congress in 2008 to oversee expenditures of the \$700 billion Troubled Asset Relief Program (TARP), is particularly concerned about the nation's small banks, because these lending institutions are responsible for about half of all small business loans. That is significant because small businesses have accounted for about 45% of all job losses during the current economic downturn. Small businesses also have been responsible for about one-third of all jobs created growth during the last two economic expansions, according to the COP. "The withdrawal of small business loans because of a disproportionate exposure to commercial real estate capital creates a negative feedback loop that suppresses economic recovery," the COP report stated. "Fewer loans to small businesses hamper employment growth, which could prolong commercial real estate problems by contributing to higher vacancy rates and lower cash flows." Of the \$1.4 trillion in commercial mortgage debt projected to come due through 2014, about half is underwater, meaning borrowers owe more than the properties are currently worth. Since 2007, owners have seen their property values fall by an average of 40%, the report stated. In late January, the COP held a field hearing in Atlanta on the issue of declining real estate fundamentals and property values and the impact on the banking industry. Property values in the metro Atlanta office sector have fallen by 50% from their peak in 2007. Meanwhile, 30 Georgia banks have failed since August 2008. "Many experts believe that Atlanta's experience could foreshadow a problem that could echo across the country," said COP chairman and Harvard law professor Elizabeth Warren, during the hearing. Brian Olosov, managing director with Atlanta-based law firm McKenna Long & Aldridge LLP and an adjunct professor at Emory University, testified at the Atlanta hearing, which became part of the COP report. The first step to recovery for the small banks, Olosov says, "starts with the recognition of the scope and the implications of the problem." The COP's findings provide a balanced view of the critical issues facing the commercial real estate industry and the U.S. economy, he adds. "Here in the state of Georgia, we have one out of three banks under some level of enforcement authority," explains Olosov, who also provides expert witness testimony in disputes involving commercial mortgage-backed securities. "A lot of those smaller banks are in communities that are underbanked. Even if you aren't under an enforcement authority, you're living under the fear of going under an enforcement action," says Olosov. The federal government's decision over which banks will be allowed to fail and which banks will be allowed to live to fight another day has been a controversial question throughout the recession. In part, the issue has become heated because there are no easy fixes, no palatable choices. The COP recognizes in the report that if banks are forced to take write-downs on commercial real estate loans, many more will fail, potentially causing serious harm to the nation's financial system. On the other hand, until the billions of dollars of these commercial property loans are written down, no meaningful recovery can begin. As a lender, Mesa West Capital co-CEO Mark Zytka is familiar the conundrum expressed in the COP report. "If banks recognized all their losses now, it would most likely translate into a flurry of distressed real estate in the market, which would be good for potential buyers of real estate," he says. "However, banks would most likely not have sufficient capital levels to survive the extraordinary level of losses across their loan portfolios." Prior to the credit crunch, Los Angeles-based Mesa West was primarily known as bridge loan lender. Mesa West has since expanded its business to include making low-leverage loans on cash-flowing properties with strong sponsors. Federal regulators are now charged with the task of finding a way to work through

the bad commercial real estate debt without causing massive small banks failures that would trigger an even more painful and prolonged U.S. economic recovery. Olasov recommends a structure that would move problem assets out of the banks in a manner that would not impair the banks' regulatory capital. "What I have in mind is a form of forbearance that moves these assets into the hands of entrepreneurial investors to start maximizing recoveries," he says. Currently, many banks are faced with the following scenario: A bank holds a \$1 million loan, which it carries on its books at \$950,000. Because of the prevailing bid-ask gap in the marketplace, a buyer comes along with an offer of \$500,000. The bank would like to remove the loan from its books, but to do so would require it to recognize a loss of \$450,000. "If I do that with respect to a bunch of loans on my portfolio, I become undercapitalized according to the regulators," says Olasov. Regulators so far have opted to support banks through a combination of bailout programs and low interest rates, and they've allowed the banks to push off the recognition of bad assets for another day, says Zytko of Mesa West Capital. Some of the more well capitalized banks, however, have been able to start taking write-downs. Mesa West has recently financed two note purchases from banks that were sold between 50 and 70 cents on the dollar. In addition, Mesa West is currently in the process of closing another loan for a Class-A office building in Southern California that was purchased in 2008 for roughly half its 2006 purchase price. Both transactions are examples of the availability of capital for assets that have had their values reset, says Zytko. "There is a lot of capital on the sidelines waiting to be invested as this process continues to work its way through the system." **(National Real Estate Investor/Sibley Fleming)**

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Retail the Bright Spot in Denver-area Commercial Real Estate Sales

Mary Sullivan, with fellow CB Richard Ellis executive vice president Tim Swan, handled the \$134.2 million sale of 17th Street Plaza in May that accounted for more than half of the office-property volume last year. "There is enormous pent-up demand," Sullivan said. Sales of commercial real estate in the Denver area plummeted 55 percent last year compared with 2008, according to a report by LoopNet. Sales plunged to \$1.3 billion in 2009, down from \$2.8 billion the previous year. However, many real estate professionals expect transaction volume will recover this year as the value of best-in-class, or "core," properties increases. "We're seeing, on core properties, 20 to 30 bids per deal, like it was two and three years ago," said Mike Winn, executive vice president at Cushman & Wakefield Inc. "Competition is ferocious for quality assets." Winn said he also expects lenders in 2010 will start to sell lower-quality properties at attractive prices as leases reset to market rates, vacancies rise and income decreases. "We think we'll see less willingness on the part of lenders to extend loans," he said. "This will lead to more properties coming to market. "The low transactional volume in 2009 was held back more by a lack of properties for sale as opposed to a lack of capital. Buyers are eager to buy commercial properties again." Sales of office properties plunged 79 percent, the biggest decline among all commercial real estate sectors, according to LoopNet. Last year, \$228 million in office properties sold, compared with more than \$1 billion in 2008. The \$134.2 million sale of 17th Street Plaza in May accounted for more than half of the volume last year. "Debt was unobtainable, period," said Mary Sullivan, executive vice president at CB Richard Ellis who handled the 17th Street Plaza deal. There is demand for office properties from real estate investment trusts

and private equity funds, but because values have dropped, there are few owners willing to put their buildings on the market. "There is enormous pent-up demand," Sullivan said. "There is too little supply on the market to meet the demand." The LoopNet data indicates a 14 percent increase in retail deals, from \$487 million in 2008 to \$555 million last year. However, the analysis included a \$347.3 million transaction in which The Macerich Co. formed a joint venture with GI Partners; no real estate actually traded hands. Without that deal, the transaction volume actually declined 57.4 percent. "I've seen activity increase as prices have continued to fall, but I don't think they're done falling yet," said David Fried, senior vice president at Fuller Real Estate. "Until we really understand what our future looks like, the only projects that are going to sell are going to be the very best projects and the projects that are deeply discounted to reflect the risk people have to make to buy them." Sales of industrial properties tumbled 65.8 percent, from \$571 million in 2008 to \$195 million last year, according to LoopNet. LoopNet's research found that the price per square foot has dropped from \$67 to \$60 over the same period, but Denver-area real estate professionals say the picture is much grimmer. "We're thinking values have gone down a minimum of 30 percent or even 50 percent in some cases," said Mitch Zatz, senior vice president at Jones Lang LaSalle. "A lot of people are losing buildings to the bank right now. We're hard-pressed to get 60 percent of what a property was worth six months ago." Apartment deals dropped 59 percent, from \$693 million in 2008 to \$283 million last year. "The primary reason there wasn't more activity in 2009 was because most buyers were expecting to see a large volume of bank- owned properties, and that didn't happen," said Steve Rahe, senior vice president of Grubb & Ellis' multifamily investment group. The price per unit declined from \$78,724 in 2008 to \$70,394 last year, likely a result of older properties selling for lower prices. "Most of what sold in 2009, which wasn't very much, was apartments built in the 1960s and 1970s," Rahe said. "We saw more sales of newer properties in 2008." **(Denver Post)**

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	CURRENT	1 MONTH PRIOR	1 YEAR PRIOR
FED FUNDS RATE	.25	.25	.25
3 MONTH LIBOR	.23	.23	1.25
PRIME RATE	3.25	3.25	3.25
10 YEAR TREASURY	3.78	3.66	2.85
30 YEAR TREASURY	4.71	4.54	3.66