CROSSWATER
REALTY ADVISORS

09.16.08

The following is an article I wrote for the "Speaker's Corner" in Geoff Dohrmann's December European Institutional Real Estate Newsletter.   Ted

IT'S "OVER": EXPERIENCED WORKOUT EXECUTIVES NEEDED

As each day passes it looks like one of the great bull runs of commercial real estate is "**over**". We were already sliding into a global commercial real estate slump and that slide will likely accelerate as the turmoil in the financial markets continues (this was written just after the wild Lehmann-Merrill-AIG weekend). In early September, Business Week had a story "Global Office Space is in the Basement". Similar stories are popping up almost daily around the world. It is quite hard to believe that the job losses tied to the financial markets implosion and the rapid contraction of capital will not have a severe impact on certain markets and property types. Some places and some property types will obviously suffer more or less than others, but the office and retail markets in the US, England and Spain are clearly already experiencing diminishing values. As with many of these markets it is difficult to tell precisely how severe the problem is or is going to be as there are still so few transactions taking place. I recently received a fascinating private e-mail analysis from an old friend who was a dominant, highly respected player in the workout days of the 80s & early 90s and who has lived in China for the past six years. His e-mail made a pretty compelling case that the Chinese real estate markets are a bubble in the making and are bound to burst. If he is correct, we can add that huge, currently popular market to the future workout list.

I don't believe we are heading for a disaster like we saw in the 1980's with see-through office buildings and spec churches sitting out there on the Texas prairie. Other than the single family and condo markets, the emerging problem is not driven so much by excess development, but more by the "**overs**" --- **over-optimistic** projections which led to **over-paying** and then **over-leveraging**. On the positive side, the rapid contraction of real estate capital will mean that there is a low likelihood **over-building**. With the tightening debt markets requiring more equity and increasingly more restrictive covenants, a growing number of owners are finding it difficult, if not impossible, to refinance their debt and are facing a serious valuation and equity squeeze. A friend told me that there are over $100 Billion in commercial loans awaiting re-setting over the next 12-18 months. If accurate, that presents enormous hurdles – hurdles which moved up higher last weekend. It doesn't

take a significant drop in revenues and increase in cap rates and debt costs to wipe out the equity of an aggressive buyer. If an asset is owned in either a separate account or a commingled fund, such an aggressive investment manager may a difficult time going back to its investor(s) for more equity.

Write-downs of the type I suspect are coming will present some interesting challenges to both the investor and advisor community.

First, some advisors may be slow to admit to the problem as most of them have follow-on funds in the works. Its tough selling a new fund, if your existing funds are underperforming. That violates everything you learned in Marketing 101. Clients are becoming increasingly concerned and even distrustful as the real numbers start to dribble in. They will be unhappy over the fact that their managers might not have been forthright with them about problems in their portfolios and unhappy over the new numbers they have to report to their boards. The buzz on the street is that some US public funds have already begun to "investigate" the falling values in their portfolios and are looking at fees managers collected on previous funds which they do not have to payback to offset current losses. It will not be good for the industry, if firms are found to be "playing with the numbers" in a hope a recovery will bail them out.

Second, poor performance can have a drastic impact on an organization. Most managers have built up their staffs with bright young men and women who believe they will participate in a "pot of gold at the end of the 7-year fund rainbow". This is especially true now as we have a cadre of young executives who have never experienced challenging, if not downright difficult, markets. If they discover that because of poor fund performance there will likely be no "pot of gold", there is a very high likelihood they will seek other opportunities. This can seriously destabilize an organization and make resolving their fund's difficulties ever more difficult. I know from personal experience how just one poorly performing asset can drag down the returns of an entire fund and thus significantly reduce – or even eliminate – a much anticipated incentive fee. This will, I believe, be an even greater problem now as the recent "price it to perfection" market was so **over-heated** that it left essentially no room for error. Well, errors have occurred, some of them quite serious. Given the growing extent of the problems in the economy and thus in the real estate sector virtually any real estate investor or manager is going to suffer some problems. When the tide recedes it takes even the best boats with it. The issue is how the managers decide deal with it. My advice would be to be as open and frank as possible with your investors. The managers who are open will retain the confidence of their clients and prosper when the market rebounds – which it will do! Managers who, in that great British

phrase are “too clever by half”, may lose their clients’ support and business. We saw that happen in the US in the 90s when certain prominent managers were in denial and their clients turned on them.

Let’s look at the investors’ perspective, if these write-down’s indeed start to roll in. The obvious questions are: Do you stick with the advisors who created the problem? Who is best qualified to resolve the problem: the firm that made the investment or a “fresh face”? Recently The Economist had an article about Greg Brenneman, a well-respected corporate turnaround specialist (Continental Airlines, Burger King, Quiznos). He had several basic rules for a successful turnaround: First, “stop the bleeding”, that is, fix the immediate problems which are causing the losses. (As they say, “the first rule of holes is stop digging”.) Second, new managers are absolutely essential. As Brenneman puts it: “It’s hard for the same people who put you in the ditch to pull you out of it”. He confesses he was sometimes slow to do just that to the detriment of his turnaround efforts. My personal experience in doing corporate and asset workouts in the 1970s and 80s is essentially the same. It’s very hard for an investor to get what I call “un-varnished and un-conflicted advice” from the very people who created the problem. There are simply too many pressures on the existing managers to correctly and adequately confront and deal aggressively with the problem: overly rosy PPM projections, tattered client relations, dependence on fees, wavering staff, reputational risk and raw human emotion. They are fundamentally “**overly-invested**” in their investment decisions (pun intended) to be coldly rational. Some people may be able to morph themselves successfully from an optimistic “investor” to a tough, pro-active “workout” specialist, but I have found that to be a rare event. The odds are against it. An additional complication is that in the “good old days of the 80s and 90s” assets were either held directly by investors in separate accounts or in funds which had relatively balanced governance provisions. The more recent funds, however, have, due to the **over-exuberance** of the investors, governance provisions heavily weighted in favor of the fund managers. We may see some fascinating scenarios as investors attempt to wrestle control of underperforming assets from their fund managers. Between out-of-balance governance provisions and widely held securitized debt we may see some real control battles ahead which could make successful workouts even more challenging than in the past.

If the slump I suspect is coming actually does deepen and spread there will be a need for experienced workout executives. They may not be easy to find. As mentioned above there are not that many people in the business today who have experienced truly hard times – we simply have had too long a bull market. Many of the workout veterans from the 80s and 90s are now out playing golf or otherwise enjoying life. How then will investors find the help they need to resolve their problems,

especially if they elect to replace their existing managers? They will probably have to lure some of the "experienced hands" back into the fray who can then train new workout managers. I have found successful workout people to be quite different from bull-market investors, especially those on the acquisition side who are generally unconstrained optimists. Workout people tend to be a little more cynical and skeptical, as they are constantly confronted with solving difficult problems. The conundrum investors will face is that, despite their losses, they will need to incentivize their new workout managers. That is always a tough issue for investors to face, especially public pension boards, but they are more likely to agree to incentives for new managers rather than resetting incentives (i.e., lowering benchmarks) for the managers who created the problem in the first place.

It's going to be interesting. As Geoff Dohrmann likes to frequently remind us: "It's a whacky, whacky world out there ".