POINT OF VIEW

The Perfect Storm

Point of View is an occasional *PREA Quarterly* column offering the opinions of leading individuals in real estate. The *PREA Quarterly* welcomes opinions from PREA members on significant issues affecting our industry.

Ted Leary

DO YOU REMEMBER THE REAL PERFECT STORM? It happened on October 30, 1991, when a classic nor'easter collided with a fast-moving tropical front off the New England coast and produced one of the most devastating storms in U.S. history. I remember it because it left huge boulders high up on yards in Rockport and Gloucester, MA, where my mother lives. The book by Sebastian Junger and the George Clooney movie about the fishing boat caught in the storm took the nor'easter worldwide. Commercial real estate seems to be going through its own perfect storm.

We have had nearly a decade of fair weather in the commercial real estate world. If you just fell out of bed on those sunny mornings, you made money. It didn't always take a lot of skill. Debt was priced lower and lower by the day and was plentiful. Loan-to-value ratios went higher and higher. Cap rates compressed, so whatever you bought one day was worth more the next. Deals were quick, and underwriting was easier than ever before. "Due diligence was for sissies," as one wag put it. You could argue that it was the commercial real estate version of "no-doc" underwriting that is now plaguing the single-family debt world. Fees were coming in fast and high. Commercial real estate indeed began to resemble the subprime industry.

Until 9 to 12 months or so ago, few observers thought the subprime collapse would impact the commercial world, but it has—big time. The subprime debacle has precipitated a global collapse of the financial system, with trillions of dollars lost and debt availability disappearing. As a result, the leverage-happy world of commercial real estate is now beginning to suffer really serious pain.

As in the Perfect Storm, the winds are coming from all directions and battering our industry.

- Debt has disappeared, and many borrowers with short-term debt coming due cannot refinance.
- Those who are fortunate to find debt will likely find it at a much reduced level, as the value of the underlying asset has dropped substantially, and the price of the debt has gone up and loan-to-value levels have dropped.
- Again, for those who can find debt, it will be lower; assets' net operating income has dropped, and future income streams may be even lower as rents start to deteriorate and tenant improvement costs begin to rise.
- At the same time, the stock market and other sectors of the financial system have crashed, so the institutional investors who now drive the real estate sector have far fewer funds than any of us would have ever anticipated 6 or 12 months ago. Look at Harvard's $8 billion loss.
- Because of that lack of funds, institutional investors may not have the resources to recapitalize investments in serious need of deleveraging. We all have read the recent stories of institutional investors who quietly—or maybe not so quietly—told their investment advisors NOT to ask for any more funds—even if they are legally entitled to do so.

The result of this perfect storm is that commercial real estate values are dropping quickly and dramatically. *The New York Times* had a story recently on some high-quality investments that were made in 2008 and are already in default. Incredible, but true. It's difficult to put a precise number on the expected losses, as there are so few transactions, and appraisals often substantially lag reality. The general consensus from my friends in the business is that losses will be in the 25% to 35% range, with some assets faring better and some much worse. A lot depends on how long the perfect storm lasts. I could go on and on about the markets but won't. (A better idea is to get a copy of *Market Aftershocks and the Road to Recovery,* the annual report put out by Randy Mundt at the Principal Group with RERC and Torto Wheaton. It's well worth reading. No hype or BS!)

As one would expect, this perfect storm is having a major negative impact on the real estate investment industry—its investors and its managers at all levels. The current investment manager model was based on the concept that firms, especially in the value-added and opportunistic space, would charge "moderate" fees based on the value of assets under management and would receive their entrepreneurial profits through performance fees. Those performance fees are going to be hard to achieve these days. I have heard that funds that were "in the money" just a year or so ago are now underwater. And as I have mentioned before, once a fund starts to get poor, let alone negative,

numbers, it is almost impossible to recover enough to produce incentive fees. I have heard that some managers accrued quite healthy incentive fees over the past few years but are now finding that those fees have been wiped out by recent valuation drops. Adding to that problem is the reality that their asset-value-based income is going to drop as write-downs begin to work their way through their portfolios. As possibly too many managers are staffed at a level consistent with the "hot years," they now have to face the cruel requirement of staff layoffs. Those have already begun—at firms large and small, global and local—and are likely to spread.

As this storm strengthens, the institutional investors are beginning to ask:

- "Just who is now managing my assets?"
- "Are my assets appropriately valued—that is, have my managers taken the correct write-downs?"
- "Am I paying the right asset management fees?"
- "Are the much-touted 'congruencies' or 'alignments of interest' between investors and managers still working as they should?"

I would suspect that virtually every investment manager in the business is under stress of some kind or another, except for those prescient few who sold most of their assets before the perfect storm hit. To mix metaphors, when the tide goes out, it takes the yachts and the dinghies out together. Everybody is impacted. The firms that were "late arrivers" to the business are probably the most vulnerable to real problems, as they raised their money late in the cycle and invested at the peak of the market, often using short-term debt. If they don't have some pretty deep pockets—both their own and their investors'—they could hit the wall over the next year.

So What Do You Do?

If you are a manager, you hunker down, reduce your costs, and work your assets like mad. Equally important, you keep your investors well informed about the status and value of their investments AND you keep them well informed as to the status of your organization. This is a time when following the no-surprises rule is imperative. I personally believe that the managers who are open and honest with their investors will have the highest likelihood of surviving this perfect storm, but firms that try to obfuscate problems or play with asset values and/or fees will lose the confidence of the investor community and may not be around for the recovery.

If you are an investor, you probably want to do something like what we call a "congruency audit" just to make sure the alignments of interest are really still there, and your managers are heading in the right direction with and paying appropriate attention to your investments.

One of my old Lowe colleagues once dropped into a sentence the word *fetch* in a most unusual manner. I asked what he meant. He said that fetch is the distance a wave travels before it hits a solid object, such as land. For example, in the real Perfect Storm, some of the waves that sank the fishing boats likely began off Antarctica. So let's hope the fetch of the real estate perfect storm is a much shorter distance. ■

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