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FOLEY & LARDNER LLP

MARCH 2009

Buying "Bargain" Real Estate Assets

The decline in the commercial real estate market across many geographic areas and asset classes has awakened interest in aggregating capital to buy commercial real estate assets at bargain prices. Will those in the industry look back in five years and remember 2009 – 2010 as an era of great buying opportunities during which capital aggregators made their best deals and achieved their highest returns? Or do prices have further to fall and will they recover slowly, leading to disappointing returns? Not surprisingly, the answer to these questions is probably "yes," depending on the asset type, the geographic area, and the characteristics of the specific asset.

Without a doubt, great acquisitions will be made in 2009 – 2010. Sometimes luck and being in the right place at the right time will play a role, but those with the greatest measure of sustained success over this period will be those who are selective and pay great attention to detail. Here are a few guidelines to consider:

1. Have a View on the Economy and Economic Recovery. It is easy to simply brush this aside and conclude that no one can reasonably predict the future of our economy. While this is understandable, how do buyers ask financial investors to provide them with capital to invest if they cannot articulate what they believe will happen with the national economy over the next few years and how it will affect the value of the assets they propose to buy? Buyers will likely need the advice of experienced, third-party professionals on such issues. While it adds upfront costs, it also lends credibility and a measure of liability limitation. Any advice buyers obtain, even if it is couched with the usual assumptions and disclaimers, should be in writing, specific to the buyer's business plan — not off the shelf — and the conclusions should be freely disclosed to investors. Examples of some subjects that should be covered:

- Long-term trends in gross national product, unemployment, taxation, and inflation
- Timing and rate of recovery of financial institutions and other providers of debt capital
- Projection of commodities, construction material, and energy costs
- Adjustments in long-term values of foreign currencies
- Impact of current demographic trends
- Extension of these general economic trends to specific target markets and assets types

2. Leverage. In the past, real estate investors have achieved high rates of return on equity through leverage or debt capital. Currently, debt is difficult to obtain and, if available, is expensive. This seems unlikely to change significantly until 2010 at the earliest. There are three very distinct approaches to this issue:

- Buy only those assets that have the best chance of being financeable, including multifamily or other assets eligible for agency or government assisted financing; long–term, single credit tenant properties; properties that have assumable debt, and so forth
- Buy assets with short-term, high-cost bridge debt that can be refinanced as conditions improve
- Buy assets on an all-equity basis with an eye toward adding debt when market conditions warrant

The third approach is clearly the safest and most flexible, but may project the lowest returns on equity. The first approach also is relatively safe, but the problem is that everyone wants these assets, so the prices may not be such a "bargain." The second approach may result in the best long-term returns, but also poses the greatest risks and will probably require personal recourse. Any acquisition strategy must clearly identify the approach and associated risks.

3. Valuation. Has there ever been a more difficult time in our respective lifetimes to value real estate assets? How can buyers estimate value? How can one project an internal rate of return (IRR)? Can one get a reliable appraisal?

Admittedly, there is very little transaction activity across most markets and real estate asset classes, and what there is comes from distressed situations. This means that there are very few, if any, "comparables." However, the other two cornerstones of quality appraisals are still there: replacement cost and net-operating income. Of course, those two measuring points also may be in flux: construction costs can go up or down and tenants may disappear, but at least those are starting points. For example, if a buyer purchases an asset at 50 percent of its replacement cost in a market that has a reasonably strong underlying economy and does not suffer from chronic overbuilding, there is a good chance that the buyer will make money over time. Similarly, if a buyer purchases assets at a 12-cap rate, which historically would have sold at a seven-cap rate, and the current tenant mix seems relatively stable and the rent levels are not above current market conditions (an important point), there is a good chance that the buyer will make money over time. If both conditions are present, the chances are even better.

The bottom lime is that, as with a view of the economy, one cannot ask investors for money to buy assets without a clearly articulated approach to valuation, supported by an independent, third-party written analysis that can be freely shared with investors.

4. Risk/Reward Ratios. The buyer's view of the economy and the process of valuation has to extend to specific markets and specific asset classes. Buyers might be able to obtain an industrial building in the upper Midwest for 10 percent of replacement cost, but still lose money. That is an extreme example, but each market and asset class has its own characteristics. The first, and obvious point, is to stay out of markets and asset classes that one does not know. It is hard enough to value assets today without the additional disadvantage of an informational blindfold. Second, buyers have to be knowledgeable enough to understand when an asset is mispriced. That is to say that its price does not reflect its risk/reward ratio. One might find real value in a limited service hotel in a tertiary market because the market typically values that type of asset in that market at a 10-cap, and one can buy at a 15-cap. However, such gifts are rare and can be based on discoverable, undisclosed problems, including deferred maintenance, changes in neighborhoods, changes in traffic patterns, and so forth.

Finally, buyers must decide whether they are going to be truly opportunistic buyers, buying significantly mispriced assets across a wide spectrum of asset classes and/or markets, or whether they are going to stick to a disciplined plan, buying only certain types of assets, at certain prices, in certain markets. Either approach can be successful, but the opportunistic buyer is taking more risk and, if successful, should receive a higher return.

5. Financial Modeling. The sophisticated financial models developed over the past 10 years can no longer be given the almost unquestioned role in underwriting that they provided in more stable economic times. This does not mean that the models are flawed. The problem is not, in most cases, with the models themselves; the problem is the reliability of the data and the assumptions. The models should still be run, with the best data and most clearly articulated assumptions possible. Then they should be "stress-tested" over a wider variety of assumptions. However, in the current volatile market conditions, the models must be used as one of many tools, and not the only, or even the most important one.

6. Experience and Track Record. Perhaps no single issue has created as much confusion among sponsors and investors as how to translate the experience and track record of the sponsors and managers in current market conditions. It is no longer sufficient to show the great return to investors delivered between 2002 – 2007. Very few sponsors or management teams can show a successful track record in acquiring distressed real estate assets in current market conditions. At best, sponsors can point to a seasoned management team with deep knowledge of the target markets and asset classes and, as to more complex asset classes, value-added management expertise.

7. Buying Mortgages Instead of Hard Assets. There are circumstances in which buying an existing mortgage on an asset makes more sense than buying the asset itself. The most fundamental reason to bypass the owner is to obtain ownership of the asset through foreclosure at a lower cost. However, litigation, junior lien holders, bankruptcy, loss of tenants and vendors, and damaged property "image" pose challenges to foreclosing lenders, so buying distressed loans is not for the inexperienced or faint of heart.

The bottom line is that there are likely to be wonderful acquisition opportunities available in 2009 – 2010, but it will not be "easy" money. To be successful will take knowledge, experience, a carefully thought out plan, and disciplined execution.

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