

View From The Field

August 2009 - We are fortunate that we have the opportunity to serve on the front lines of real estate finance. Our view, while not a full field of vision, does provide us with some amazing insights as to what is actually happening in the space. The dynamics of real estate finance have changed faster over the last nine months than they have over the last decade. These changes have impacted all participants and we expect that much of the change is here to stay.

How we got here...

As perspective, the last monumental change we witnessed in real estate finance was the evolution of a market for syndicated commercial real estate debt (commercial mortgage backed securities, CMBS). Real estate mortgages had been syndicated (carved into pieces and sold) for years but it was primarily residential-backed mortgages where only the top-rated (lowest risk) piece was sold. The rest of the issue was held by the issuer who retained a substantial portion of the risk. In the late eighties a market began to develop for the "B-piece" of the issuance, and this evolution allowed the risk to be shifted away from the originators. The result was an increase in origination volume with a peak in excess of \$315 billion in 2007. This liquidity source dried up abruptly in 2008.

The driving force behind the explosion of CMBS was the emergence of a robust origination engine centered around conduit lenders. Conduit lenders (which sprang up like mushrooms overnight at most of the large banks and commercial finance companies) originated real estate loans, warehoused these loans, and then sold them as packaged securities (CMBS). Over time, from the early nineties to 2007 the underwriting standards of the conduits were increasingly relaxed as the demand for CMBS grew. The explosion of CMBS also had the effect of eroding underwriting standards at commercial banks that were originating construction debt. This erosion of standards resulted as the banks tended to underwrite to their takeout, which were the aggressive conduit programs. Then suddenly, with the onset of the global credit crisis, the demand for CMBS dried up and conduit lenders began to die out. The failure of the securitization engine has been a tremendous set back to the real estate industry. Permanent financing through conduits was geared to income-producing real estate but it also benefited non-income producing real estate development by flooding the industry with capital. Commercial banks are the primary source of development and construction financing. The presence of a highly liquid secondary market for income-producing properties provided commercial banks with a release valve for their balance sheets. In fact from 2004-2007 this release valve sometimes worked too well, creating a drain so strong that most lenders were fighting a runoff problem. Loans were in some cases disappearing faster than they could be originated and competition was fierce. It was a borrower's market. However, the life blood of the commercial banking system is the presence of a functioning release valve for the balance sheet. If the valve fails to work, the balance sheet backs up and the system can no longer take on more production. This is the situation we are in today.

The current reality...

Construction and permanent financing is difficult to obtain as the originators are few. It's a lender's market. Bank lenders are dealing with an over exposure to real estate and other balance sheet and regulatory issues. Life companies are still lending but due to the demand they're able to be highly selective and their underwriting is extremely tight. The question then is when we will see the return of a functioning real estate finance market. It's a difficult question but at minimum it will take the return of a secondary market. Until banks can drain off their exposure, the market will remain in a semi-frozen state. Even after a functioning secondary market returns we may see a slower thaw as it will take time before banks' balance sheets shed enough commercial real estate to allow them to become active originators.

What is getting done?

An important lesson learned, having grown up fishing the back country of southwest Florida, is that if you want to find and catch fish you have to position yourself where there is a good supply of food and oxygen. It's the same in real estate finance. Construction loans are being funded in the segments where permanent financing exists; for example, agency lenders like Fannie Mae and Freddie Mac are originating takeouts for multifamily deals. Unfortunately, the fundamentals for multifamily have begun to weaken and the agencies are tightening their underwriting further limiting capital availability. Another segment that is moderately active is financing for smaller projects (financing under \$5 million) with limited speculative risk that can be placed with community banks. There are some large transactions getting funding but generally these will have significant equity positions (in excess of 40% cash) and very strong sponsorship.

Is the time now?

Is now a good time to invest in commercial real estate? The answer--it depends. Many pressures are facing commercial real estate, not the least of which is the lack of credit. Retail, office, and even multifamily are encountering strong headwinds with respect to maintaining occupancies and NOI. Tenants are pushing back hard on lease rates and occupancies have decreased in all property classes. Given these facts it makes the purchase of an income-producing property based on in-place NOI a challenge. Underwriting is paramount (as it always should be) and each deal must be analyzed independently. Have rents been renegotiated (or is that shoe yet to fall)? What is the tenant mix? How are the tenants' businesses holding up in the recessionary environment? What is the capital structure that would be employed to purchase the asset? These uncertainties have tended to push up cap rates, and we have seen a wide spread between the bid and ask. If an investor has cash to deploy, the process to deploy that capital should be very strategic and not rushed. The market is likely to get frothier before it improves. That said, if a property can be purchased at a level that meets the investor's return requirements after vigorous underwriting, then execute. Discipline is always important; but in an environment where the pressure on values is downward, discipline is paramount as there is no room for error (i.e. appreciation, increasing rents, or higher future occupancies will not bail you out for a long time to come).

Recent Redfish Accomplishments...

<p>Construction Financing \$13,550,000 192 unit Multifamily Complex Huntsville, Texas</p> <p>Lenders Amegy Mortgage Capital & Allegiance Bank of Texas</p>	<p>Construction Financing \$16,000,000 192 unit Multifamily Complex Conway, Arkansas</p> <p>Lender Centennial Bank</p>	<p>Bridge Financing \$800,000 Land Acquisition of a Planned Retail Center Asheville, North Carolina</p> <p>Lender Bank of Asheville</p>	<p>Investment Acquisition \$1,300,000 Net Leased Burger King Weaverville, North Carolina</p> <p>8% CAP Rate</p>
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About Redfish Advisors

Redfish Advisors LLC is a real estate investment advisory firm who provides counsel to real estate investors and developers in their acquisition, disposition, development, and financing activities. Our work can take many forms and our involvement can range from a single task to a comprehensive engagement.