

State of the Private Debt and Equity Capital Markets

As the market spends the early part of 2008 (or longer) equalizing pricing, significant amounts of capital are being assembled and readied for deployment into more “value-oriented” markets.

AS YOU READ THIS ARTICLE, there is a high probability that both public and private debt and equity markets have changed dramatically since this was penned. In fact, these markets have changed so drastically even in two weeks of late January 2008 that it is nearly impossible to consummate a real estate financing transaction on all but the highest-quality deals.

Generally, three things influence the cycle of ups and downs in the real estate finance world: liquidity, confidence, and fundamentals.

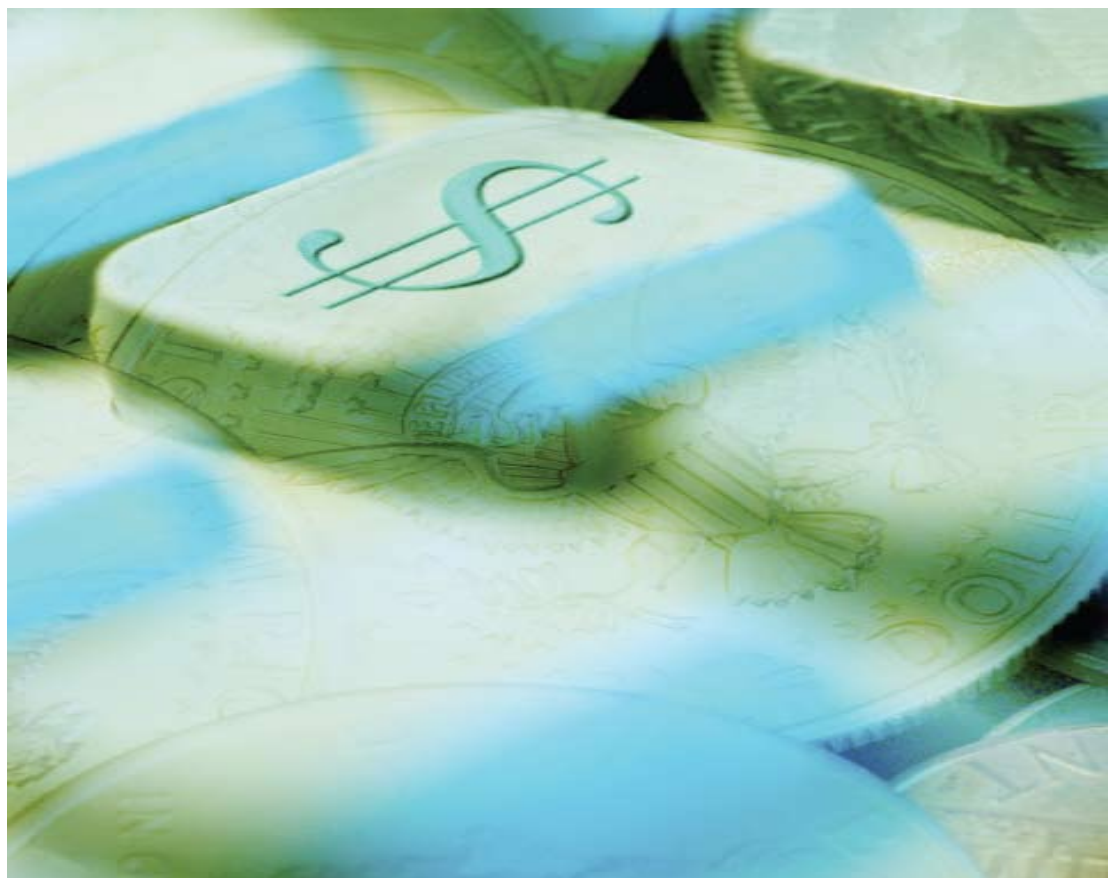
Liquidity. Clearly, the lack of liquidity in the real estate capital market today is unlike any other since perhaps the late 1980s. Where the capital is and what it’s doing will be discussed later.

Confidence. What is starting to affect the capital markets—in addition to the well-publicized credit crunch—is an overall lack of confidence in the real estate “futures” market. Just as investors look to futures to forecast interest rates as well as stock and bond prices, similar inferences can be gleaned by studying investor sentiment in the future of real estate fundamentals. In fact, equity investors are beginning to adjust their models to reflect a much more conservative set of assumptions. This, coupled with far more conservative debt underwriting, is enhancing the already present disconnect between bid and ask prices for commercial real estate in the United States. As debt and equity investors get

more conservative, we will see real estate values decline and the opportunity for discounts increase.

Fundamentals. What haven’t shown themselves—at least not at a significant level—are eroding real estate fundamentals. Capitalization rates have increased, sometimes significantly, in some small- to medium-sized cities. But for the most part, cap rates in major markets have only adjusted mainly due to cost of capital modifications.

What has to happen in order for this logjam to break? First, there needs to be an acknowledgment that things are not going to get better soon. A slowing economy will eventually have an impact on commercial real estate fundamentals. We’ve already witnessed what has



happened in the housing markets. As fewer rooftops go up, there is less demand for new retail space. Retailers have been very clear in the last three months about their plans to scale back opening new stores. With less inventory, there is less demand for an increase in new warehouse space. The only way warehouses prosper in today's market is if people stop buying the goods already in stores—a paradigm that leads to far more significant economic issues. In addition, we've seen an obvious pullback in new stores from the home improvement sector. Lowes and Home Depot, for example, have both announced that they will reduce the number of new stores in 2008. And we all know that Starbucks announced that it will, for the first time, close some stores. Also, we've just heard the news that Chicago-based furniture company Wickes will liquidate. And Sears Holdings Corporation, parent company of Sears and the Kmart stores, is getting substantial press about an ominous future.

In secondary and tertiary markets there will be much more discounting. Discounting will come primarily from two sectors: nonperforming real estate, and properties unable to recapitalize due to changes in the capital markets.

Right now, most of the underperforming real estate is in the for-sale housing sector and some office properties that need large capital infusions. One would expect this to flow into the more mainstream product types including retail, industrial, and hospitality.

As for capital markets-driven discounting, we've all read about Harry MacLowe's situation. In fact, many large institutional borrowers have financed their business with short-term floating-rate debt. As this debt matures, these borrowers are unable to repay it due to an illiquid capital market. In fact, Australian shopping center giant Centro can

attribute much of the blame for its recent woes to these recapitalization issues. Lastly, Ian Bruce Eicher defaulted on more than \$750 million in debt last month on a high-profile \$3 billion-plus mixed-use development in Las Vegas.

If sellers begin to sense that their assets are not going to increase in value, and may see further erosion in values, they will begin to unload them at discounts.

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Capital Markets

First, it is helpful to know what's going on with the traditional debt and equity providers.

CMBS. The commercial mortgage-backed security (CMBS) markets are, for the most part, dead. While initial projections had this credit crunch lasting only a few months or so, it is now clear that this situation has blown up into a very significant liquidity crisis in the CMBS world. Existing bonds are not being sold and new mortgages cannot be priced. What was most recently a \$250 billion market may drop to between 10 to 20 percent of that amount going forward. This illiquidity is most apparent by viewing the amazing run-up in spreads.

Life companies. Life companies, while initially anticipated to step in and reclaim market share, have cut their real estate allocations drastically. They are increasingly selective and are adapting a more conservative set of underwriting criteria. In addition, they are beginning to stockpile cash that will be used to shore up broken investments and take advantage of opportunities when the market recovers.

Banks. Local and regional banks have stepped up their new origination efforts, but two questions remain. Will they lend enough to

absorb the shortfall in CMBS and life company originations? And will federal regulators allow these banks to keep lending? The hope is that banks will underwrite risk appropriately to keep from simply pushing off another liquidity issue at the time of loan maturity.

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Big money center banks have taken extraordinary hits due to their exposure in subprime and derivative markets. These banks are playing only nominally in today's markets.

It's not likely that banks will make up the \$200 billion shortfall in capital that has left the market.

The Opportunity

There is no telling when or if discounting will happen, but if and when it does, there are pools of capital being assembled to take advantage of the opportunities. This money is being raised by investment bankers and is primarily funded by commitments from opportunistic investors and private capital

sources that have managed to keep their exposure minimized during this period.

As in any period of disruption, one of the main short-term sticking points of recovery is how capital finds those in need. Traditional capital distribution channels have been compromised and new channels are only slowly being formed. The catalysts for the formation of these new channels are the high-quality real estate financial intermediaries. This group makes its living moving debt and equity capital and is again the primary vehicle for matching up these two interests—those with capital to invest and those needing capital investments.

There is also the area of "bad debt" that needs to be addressed. It has not really started happening yet (except in the condo sector), but at some point in the real estate cycle, properties go back to lenders. Another major sticking point in the process is what do lenders do with real estate owned (REO) properties? Again, it's the role of the intermediary to facilitate the movement of capital from those looking to invest to those needing an investor.

One thing is for sure: the real estate capital markets have changed drastically. Money will be priced differently going forward and underwriting will be much more critical. We're coming into a time when real wealth can be created. Those with access to opportunity capital and access to opportunistic transactions will be rewarded in the long run. **UL**

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