Solid Commercial Real Estate in Uncertain Times: The Quiet Strength of Good Management.

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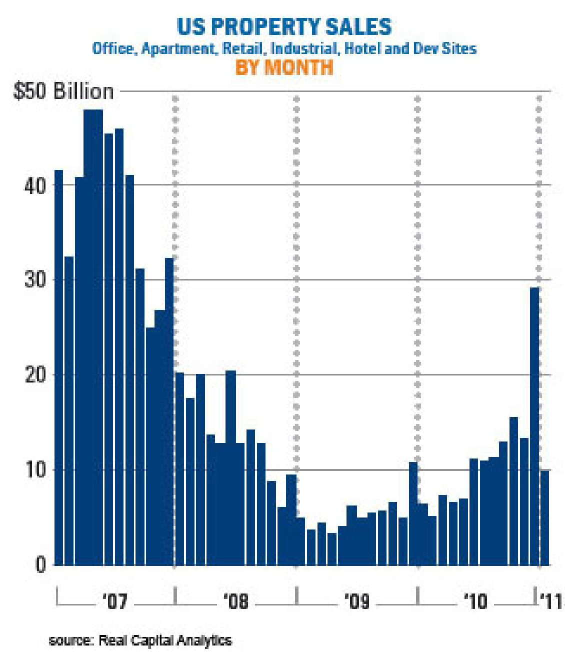
With the worst days of the downturn seemingly behind us, investors, lenders and principals are starting to pick up the pieces. It may very well be a good time to invest, with a large number of troubled loan portfolios from community banks likely to come on the market. But these opportunities do not come without risk. They require a careful, nuanced and strategic approach – standard underwriting and valuation alone will just not tell you what you need to know.

The persistent phenomenon of the economic recovery continues to be that of two separate markets. On one hand core metropolitan areas, especially coastal gateway cities are witnessing cap rates and purchase prices on par with pre-recession levels and a kind of bidding war for the best quality stabilized assets, particularly in multi-family. The rest of the country, especially in secondary or tertiary markets, continues to exist in a state of limbo, with little interest from capital and continued distress as the fundamental demand for space has not returned.

Despite the bifurcation of the market, we seem to be in a real recovery. Led by core metropolitan areas, first quarter of 2011 showed an increase in sales, stabilizing rents and slowly improving employment. According to Real Capital Analytics, the first two months of sale as shown by the bar graph to the right in 2011 totaled $17.6 Billion. For January and February 2011, sales volume based on price increased 57% over the similar period for the prior year. According to the FDIC, defaults in the 4th quarter of 2010 actually fell from 4.36% to 4.28%.

According to a recent survey by Kingsley Associates and Institutional Real Estate Inc. (IREI), North America's largest tax-exempt institutional investors expect to invest more than $30 billion in commercial real estate in 2011. Commercial real estate almost by default has become one of the best asset classes for risk-adjusted returns compared with U.S. and international equities, fixed-income, venture capital and private equity investments. However most of the activity and enthusiasm so far has been limited to core metropolitan markets. The velocity of real estate economic recovery elsewhere has been much slower. The lack of liquidity in non-core markets and weak economic employment fundamentals has discouraged institutional investors from returning to those markets too quickly. However, at

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market – and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.



this time, due to overheated pricing in core markets, resulting in limited opportunities for meaningful yield, investors may be willing to look beyond those for higher returns. According to a recent article by the National Real Estate Investor, "… with heightened tensions in the Middle East, foreign capital pouring into the United States and prices reaching pre-recession levels, institutional investors are hoping to achieve higher returns by exploring opportunities in America's heartland." This is where the market starts to get interesting, and where executing the correct level of due diligence becomes imperative.

Summer Street Advisors recently completed a successful engagement on a national multi-family portfolio where the ability to understand the collateral and evaluate the property operations/management was crucial to the overall analysis. In today's market, it is not enough to just glance at a property's income and expense statement. Investors need to understand why a property is meeting with its success or failures. Is it an overall market condition, or how the property is being managed? Recognizing the difference is critical in determining how a property will operate going forward.

Given the quick return to pre-recession cap rates in core markets, this recovery is unlike previous recoveries in that discounts on distressed assets are simply not deep enough to allow for investor mistakes. The worst of the recession may in fact be over and prices in some markets are again heading upwards. While this may be good news for banks and the state of the economy as a whole, it has not made the investor's job any easier. Compounding the difficulty of assessing investments are the various uncertainties that still hang over the economy. Even if there is no double-dip recession, the specter of potential inflation in the years ahead as well as rising interest rates will surely impact the ability to meet return expectations; no matter how well a property performs. Furthermore, possible changes in the role of Fannie Mae and Freddie Mac in the commercial real estate market should raise questions about any exit strategy in the next five years.

James Sellinger, an independent asset manager and workout consultant recently commented, "In this recovery, you cannot rely on the general market to push up all values to pro-forma, but there are properties out there, in core and secondary markets that will continue to consistently perform. Location, as always, is crucial to a property's success, but more than anything else, it is the quality of operations that determines the success – even though it is easy to overlook during periods of market expansion."

Sellinger continued, "Investors have to understand that commercial real estate – and multi-family in particular - is a very management intensive business. And independent of the current state of capital market interest in a given market, it is the quality of that management that makes the difference between a successful and a failed asset."

Jack Mullen, principal of Summer Street Advisors agrees, as much of his recent work with investors has focused on determining the quality of management and operations in prospective investments. "In an uncertain market, the quality of the operator becomes even more critical. If you don't have a solid understanding of the market/property and just clip the coupons – even with a seemingly stable asset, you stand a better chance of getting hurt by the external factors. That is why investors, especially as they are forced to move away from their original investment thesis and towards areas of less liquidity, have to make sure they assess property level management carefully. Management is what will create your leasing stability, which in turn is what's creating value in good times and bad!" According to Sellinger, "Too many buildings can look good from the street or on paper, but due to weak management, end up becoming a problem." That is why both Sellinger and Mullen recommend that investors pay close attention to the following five key factors when underwriting the operators of a property:

1. Does the operator have an in-depth understanding of the sector and the market?

2. Does the operator have a good financial position? How heavily leveraged are they?

3. Does the operator have a long-term strategy for the asset?

4. Does the operator have an intensive and systematic process for managing tenants and properties?

5. Does the operator have a deep local knowledge, including neighborhood, demand drivers, and in the case of multi-family assets, schools?

There are certainly outstanding opportunities in a recovering market like today, and in a few years many investors will be pleased with their decisions from 2011. It is important to keep in mind that success over the next few years may very well be determined by a willingness to take a longer view. According to Mullen, "Slow and steady will most likely have an advantage over impatient money. The operators willing and able to build relationships with their tenants, to invest time, expertise and even capital in the long term viability of an asset will fare better despite any new changes in the market. No matter what happens with interest rates, inflation, Fannie and Freddie – good management on the ground will not only mean survival, but success over time."

Summer Street Advisors LLC (SSA) is a commercial real estate and financial services advisory firm. SSA offers a rigorous, data driven approach in providing commercial real estate and loan investment valuation and analysis, transaction due diligence, bank and REIT advisory, asset/portfolio management and loan underwriting.

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