Jack Mullen, Founder and Executive Director

Summer Street Advisors

January 2014

Real Estate Investment 2014: Balancing Prudence, Opportunity

2014 is likely to be a strong year for the commercial real estate debt and equity markets, in terms of deal volume and investor yields relative to many other asset classes. It may also be a pivotal year, when investors, lenders and underwriters reveal how well we have learned the lessons of the past.

Many factors contributed to the global economic crisis five years ago, but an important element was the abandonment of sensible lending standards in home mortgages and, to a lesser extent, commercial loans. As competition for deals intensified, investors accepted lower yields for higher and higher levels of risk. Somewhere along the line, the market passed from prudent investment to short-sighted opportunism. But when exactly was that line crossed? And more important, will we recognize it when we see it again?

Commercial Real Estate (CRE) markets are improving and outperforming many other asset classes. Investors from around the world are looking at U.S. real estate markets, including both equity and debt opportunities across an expanding range of property types and geographies. Property performance measures such as occupancy and average rental rates are moving in the right direction in most markets, although net absorption nationally has been below historical averages.

The market recovery has been aided by a lack of new construction, but that is changing. Commercial construction climbed by about 15 percent and multifamily development jumped by 23 percent in 2013, according to McGraw Hill Construction. The intensity of capital in the market suggests that the acceleration of new development will continue. But can broader market indicators such as GDP growth and job formation support development at the level that capital sources would like to fund?

2014 could be the year we start to see answers to those questions. Without trying to predict the future, we can gain some insights on what this year will bring by first looking at recent performance and trends of three types of CRE investment: CMBS, direct equities and REIT markets.

CMBS

Issuance of commercial mortgage-backed securities totaled about $75 billion in 2013, far surpassing the $48 billion issued in 2012. Last year was the best year for CMBS since 2007, when the frenzy of the credit bubble pushed volume to $230 billion. By May of 2008—months before the economic collapse—Moody's was predicting an 85 percent drop in year-over-year issuance. At the time, some market experts estimated that $50 billion to $100 billion would be a normal range for stabilized annual issuance going forward.

Then, CMBS issuance was virtually non-existent for a few years, leading to pent-up demand from borrowers and investors alike. Based on loans with upcoming expirations, CMBS volume may reach $88 billion in 2014 and exceed $100 billion in 2015, according to a study by Urban Land Institute and Ernst & Young.

The CMBS market will be one of the beneficiaries of improved U.S. GDP growth over the next two years as well, according to Moody's recent Outlook on Global Credit Conditions GDP growth expected to be between 2 and 3 percent in 2014 and accelerate further in 2015. Asset-backed securities in the structured finance arena represent another sector poised for dynamic growth, as well as banks, state and local governments, and the lodging and retail sectors. A positive future for business sectors that include real estate lenders and borrowers is further evidence that CMBS volume will be strong.

However, growth estimates are predicated on the idea that borrowers who need financing will be able to get it. What if properties with expiring loans don't meet the criteria for refinancing? As borrowers needing money collide with capital sources eager to invest, underwriters will be under increased pressure to relax their criteria, and rating agencies may be tempted to grant investment-grade ratings to pools that fall short of prudent standards.

In fact, we saw some of this trend in 2013. In the second quarter, rating agencies were raising concerns about insufficient credit enhancement and excessive LTV ratios on deals rated by others. By summer, some loans were getting "kicked out" of CMBS pools because they threatened to drag down entire deals. So far, it appears that the safeguards are holding back the tide of poorly structured deals; however, investors are wise to perform their own due diligence before making big bets on CMBS in 2014.

Equity investment

Global equity capital flows in the first three quarters of 2013 were 21 percent higher than 2012, and by year-end investment was expected to reach $475 billion to $535 billion, according to Jones Lang LaSalle. Volume in 2014 is expected to be 10 percent higher.

For example, Washington Real Estate Investment Trust recently sold its 1.5 million-square-foot medical office portfolio to a private buyer for just over $500 million, or about $329 per square foot. The deal positions the REIT to refocus its portfolio on core investments in high-end office, retail land multifamily. But it also shows a growing appetite for investment in asset classes with limited investor appeal five years ago.

With an abundance of capital looking for deals, investors are looking at a broader range of properties in more and more markets. The hotel market, a bellwether of investor willingness to move beyond four core property types, jumped 61 percent in the first three quarters of 2013 compared to 2012. And cap rates on core properties are at their lowest ebb since 2007, according to PREA.

As 2014 gets under way, U.S. secondary markets are getting more attention from investors than they have in years, and foreign markets that have seen little or no interest for several years, such as southern

Europe, are regaining their footing as investors go farther afield for deals. Meanwhile, new capital sources are continually entering the market. This expansion into new properties and markets may enable increased levels of demand to be met without forcing investors to engage in speculative pricing.

Despite the strain on cap rates, investors so far have been able to realize positive going-in yields, and a strong argument can be made for upside on increasing values over time. So the market is stable at the moment, but if discipline is not maintained, the risk exists that the market could enter a speculative bubble in 2014 or beyond.

REITs

Publicly traded real estate investment trusts took a hit in 2013 as the market reacted to news that interest rates could start climbing. As a result, total 2013 investor returns on REITs were notably lower than those on the S&P 500. But capital raising for REIT IPOs and follow-on offerings has continued at a strong pace into 2014, and this year is expected by many to be a ripe period for M&A activity for REITs.

A wave of new REIT IPOs in 2013 has several market implications. First, it increases competition for property and portfolio acquisitions, creating further pressure on yields. Second, it creates a larger pool of M&A candidates for established REITs, which may find it easier to grow by acquiring other publicly traded entities than by competing for properties one at a time. Perhaps most obviously, the strong IPO market shows the increasing willingness of institutions to invest in REIT shares—and to structure private acquisitions as single-asset REITs—in order to gain liquidity and simplify the process of calibrating portfolio allocations to different property types and markets. Concerns that REIT share values would be discounted compared to private equity structures appear to be diminishing, as investors note that history has not shown a pattern of discounting.

REITs are adding debt to properties to leverage yields and increase working capital for acquisitions. Although it's rare for a public REIT to become so overleveraged that its survival is threatened, it could happen more often in the future, if investors and underwriters let down their guard. Just as with the CMBS and direct equity markets, investors and lenders must maintain prudent standards in underwriting REIT debt.

Maintaining balance

In the early stages of any market upswing, when opportunities are plentiful and competition is scarce, it's almost impossible to make a bad investment decision. We're now further along the curve of a CRE market recovery, where there is more competition and more risk, but many great opportunities still exist.

As markets continue to gain steam and attract more capital from more players, investors will need to be increasingly cautious as they are forced to move up the risk spectrum to get the same level of yield. If 2014 turns out to be the year that risky deals start to masquerade as solid investments, market players can distinguish between decisions based on fundamentals and those that stem from speculation.