

Charleston, South Carolina: US community banks hold large amounts of property in such markets



## Where the wild valuations are

The work of valuation professionals in the world's secondary markets is becoming increasingly meaningful as opportunistic investors shift their attention from prime locations. *By Jonathan Brasse*

One of the biggest problems for a valuation professional is thinking a property is within the 'good' secondary space but getting it wrong. In such instances, it can be the difference between being 25 basis points off in terms of the yield and 250 basis points off.

Every profession has its stress points but as Robert Peto, long-time valuations expert and vice chairman of capital markets at DTZ, points out, the ultimate fear of any valuer is gross misjudgement. "That point between good secondary property and 'crap' is the friction point where a valuer can get it desperately wrong."

The success of the real estate valuer hinges on grasping a series of variable factors that enable him to confidently arrive at a fair market valuation for a given property. The problem in most developed real estate markets over recent years was that the central variable in any valuer's calculation, comparable evidence, has often been lacking – or worse, missing entirely.

With the world's primary real estate over-pursued by 'flight to quality' investors, many of which are still scouring for the last bastions of discounted real estate, the work of valuation officers in less favoured secondary markets is poised to become more meaningful today than any time since the global financial crisis took effect.

Private equity real estate firms are, for most intents and purposes, occupying the sidelines of these marketplaces. But as time goes on, transactions by the more opportunistic players are surfacing for property in secondary locations, albeit at varying paces. Consequently, valuers are slowly building stores of evidence, enabling them to offer valuations more confidently and, in turn, play their part in getting the property markets moving again.

Last month, PERE heard from valuation experts active in the world's three most-established property markets – the US,

the UK and Japan. The common thread between them? While primary market valuations today are largely unproblematic, that has not been the case in secondary markets, though things are slowly improving.

### Value in the community

Stress points had emerged, for example, concerning the valuation of real estate loan books held by US community banks, among the largest owners of real estate in secondary US markets.

Jack Mullen, founder and managing director of Westport, Connecticut-based Summer Street Advisors, recalls in 2010 how he and his team of former GE Capital Real Estate professionals worked on a loan book of a troubled Chicago community bank on behalf of a well-known private equity firm that had been given access to the bank's books. Following assessment, the private equity firm and its advisor believed the equity value in the bank's portfolio to be zero, and it fell to Summer Street to break the news to the bank.

"Unfortunately, we were the first to deliver the message," says Mullen. The message, however, was not well received it seems. "The bank chose to explore other options." Sadly, just four months later, the bank collapsed into the arms of the Federal Deposit Insurance Corporation.

Mullen's anecdote shows that, less than two years ago, there was a general reluctance by some US community banks to accept the loss of value in their portfolios. Naturally, that stance meant few trades. However, Mullen says now, after a prolonged period of inactivity, community banks are beginning to trade their real estate positions, seemingly displaying a greater acceptance of valuations.

That's a good thing for private equity real estate, says Mullen's colleague Tyler Shubert, especially since he estimates about 75 percent of commercial property in the US sits in pres-

ently unfancied secondary markets, and commonly on the books of the country's community banks. Indeed, Summer Street research estimates there is \$30 billion worth of loans sitting with these localised custodians. Whereas these banks would accomplish half of all workouts via loan modifications just one year ago, today liquidations are prevailing six to one over modifications as accepted valuations are leading to new transactions.

Accordingly, Summer Street is positioning itself as a diligence resource of choice for buyers better accustomed to a skyscraper in Manhattan than a retail complex in Charleston, South Carolina. Key to the firm's work nowadays is determining valuations on properties held against loans granted in parochial markets riddled with inconsistent 'relationship banking', and often for the benefit of private equity real estate firms. "We're talking about the financing of small buildings - it may be 500 loans and 300 relationships," Mullen notes.

For those assets that can be traded from one world to the other, investors can expect discounts on nonperforming loans approaching 50 cents on the dollar and even discounts on performing loans of as much as 30 cents on the dollar. "If you're willing to go in and do the work, there's real opportunity," Shubert says. Furthermore, he believes there has now been enough transactional activity in the market for it to become self-perpetuating. He predicts 2012 will see more private equity real estate firms alive to that sentiment and, crucially, more confident that valuations in small markets like Bend, Oregon, for example, can be as trusted as larger ones like downtown San Francisco.

### A grim short term

Compared to the US, UK banks with the greatest exposure to secondary real estate are some way behind. With significant financing programmes in the lead-up to the crisis, Royal Bank of Scotland and Lloyds Banking Group, the two subsequently part-nationalised banks, are today among the most scrutinised lenders in the region, particularly by private equity real estate firms, for their loan books.

Mark Creamer, head of Europe, Middle East and Africa valuation and advisory services at property services titan CBRE, provides valuation services to both banks. Referencing their secondary property exposure, he says: "They've got loads of the stuff on their books, and they want to know how to get rid of it. But it's hard to do because the purchasers aren't there. There haven't been many sales."

Creamer's version of a retail complex in Charleston, South Carolina, is a development site in Castleford, Yorkshire. The difference for him between the UK and the US is that there is no opportunistic capital evaluating the site in Castleford. "The secondary market is pretty dead in the water," he says resignedly. "If you can't borrow money - and a lot of opportunistic investors rely on debt to invest in secondary properties - then you're in a bit of a Catch-22."

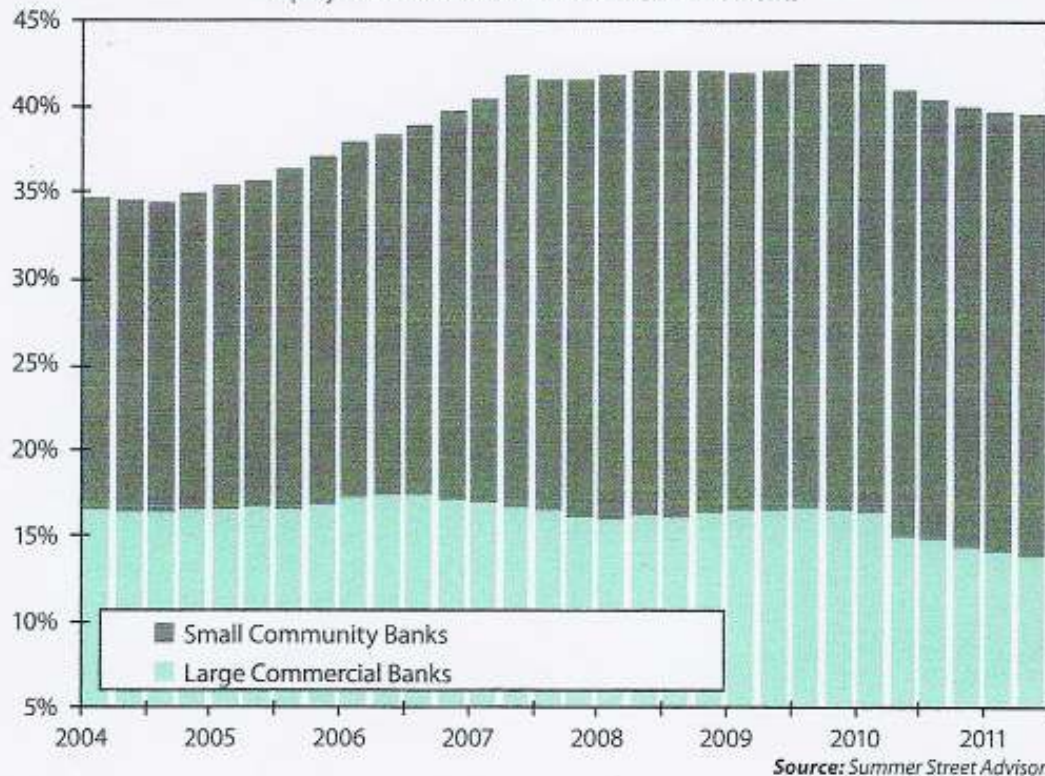
Nonetheless, both RBS and Lloyds did complete portfolio sales last year, and both to private equity real estate firms - The Blackstone Group and Lone Star Funds - in deals that are expected to precipitate more activity. Creamer would not specify whether CBRE specifically worked on the transactions, dubbed 'Project Isobel' and 'Project Royal' respectively, but he

did say: "There wasn't a meeting of minds a couple of years ago. Blackstone and Lone Star had been waiting for their moment and are now getting the opportunity to bid for things." More importantly, he points out that both sales were competitive, indicating the two firms weren't alone in accepting pricing levels for the underlying assets.

The Project Isobel sale saw RBS offload a £1.4 billion (£1.7 billion; \$2.15 billion) loan book via a complex special purpose entity aimed at enabling both RBS and Blackstone to benefit from any uplift in values. Lloyds' Project Royal offload of a £900 million loan book was more of a straight asset sale. Tellingly, both were a mix of nonperforming and performing loans, indicating how opportunistic capital in the UK still requires a certain security when engaging with

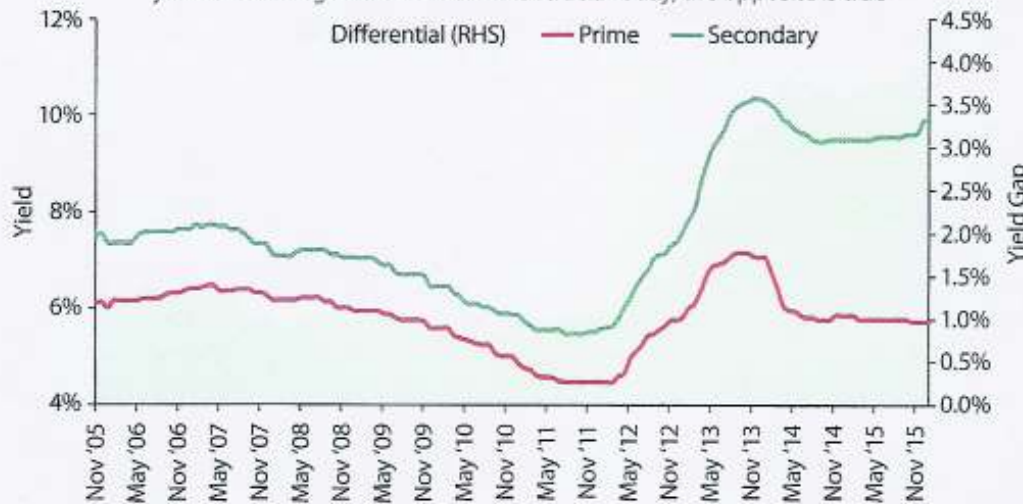
### Commercial real estate loans at US banks

With almost 40 percent of all US real estate loans held by the country's community banks, compared to 14 percent for large commercial banks, it is little wonder private equity real estate firms monitor their movements



## Prime versus secondary UK real estate

There was a close correlation between UK prime and secondary property yields until the global financial crisis struck. Today, the opposite is true



Source: CBRE

secondary properties.

As of last summer, RBS reportedly had more than £40 billion of non-core property to shift from its books, while Lloyds had a smaller but still meaningful £26 billion of non-core property. But with yield spreads between prime and secondary property "massively widened" following the downturn and Europe's sovereign debt crisis still undermining confidence in occupier demand, Creamer does not foresee his team calculating more positive valuations outside of the UK's prime markets.

"In the short term, it's grim," Creamer says. Whether from experience or in hope, he adds: "In the medium or long term, property goes in cycles; we all know that. It's going to get better." In the meantime, in the absence of more Project Isobel and Project Royal offerings, he and his colleagues can only definitively say that secondary real estate valuations in the UK "are a lot worse than prime."

### Dubious collateral

Valuation professionals in Japan, meanwhile, are preparing for a busy 2012. Christian Mancini, chief executive officer for Japan at property services firm Savills, and his seven-strong valuations team expect ¥711 billion (£7.26 billion; \$9.25 billion) of CMBS loan maturities in the country this year and another ¥1.2 trillion in 2013. Curiously, this mountain of debt for properties requiring fresh valuations is not held by Japanese lenders.

Mancini notes that US and European banks are expected to do much of the hiring as they seek clarification on large pools of assets, again much of it secondary, ahead of determining their next steps. However, while instances of foreclosures in the US and UK have occurred often enough, he believes those contemplating their Japanese exposures will take a different tact. "They're not looking to put anyone's feet into the fire," he says. "They just need a bull-free assessment of what values have done over the past 12 months or from acquisition to today."

Prime Japanese real estate values, namely in parts of central Tokyo, are recovering rapidly, Mancini states, perhaps already as much as just 10 percent or 15 percent off peak values. "The

bid-ask spread has tightened considerably, and people are willing to trade," he says. But given that many of the loans coming due in 2012 are backed with property he describes as "dubious at best," his firm is faced with valuing properties that for him best demonstrate why the global financial crisis started in the first place. "We're talking about stuff stuck out in the regions that wound up pooled, tranching and sold off," he adds.

Take, for example, a hypothetical \$8 million multifamily development in the Mie prefecture of southern Japan, an area better known for its traditional handicrafts such as

pottery than its booming real estate potential. "Maybe there's a high-net-worth guy or local property company that would take that down at a double-digit cap rate that blows out all but the senior piece of the tranche," Mancini says unconvincingly. Regardless, his firm plans to be on-hand to provide the requisite valuations when needed. Indeed, he says his team already has been seconded twice into the credit departments of banks on three-month instructions to help them ascertain what value they have in their portfolios.

Perhaps surprisingly, last March's devastating earthquake and resulting tsunami has done little to complicate the work of Japanese valuers, Mancini says. Pointing to few reactionary instances of relocations at either the individual or corporate level, he confidently declares: "Our view on the earthquake itself is it didn't have an impact on valuations." With regards to Sendai, the most-affected region, he explains that the market was only on the cusp of "showing up on the institutional radar screen" anyway. As a result, other than extra premiums on properties able to demonstrate modern seismic shock technology or multiple power grid access and the like, the event has not become an added factor for Japan's valuers.

Again, most valuations boil down to comparable activity. The bottom line is prime property is beginning to find its level and, in certain cases, transact, while there is less tangible evidence of secondary movement. From a valuation perspective, Mancini won't mind as he says 90 percent of his team's work is for lenders and, given the CMBS picture, they are in for quite a busy year of evaluation.

Overall, valuation professionals across the world should expect plenty of work in 2012, particularly on behalf of debt providers to property in secondary locations. By all accounts, that will not be easy work. As DTZ's Peto notes, the difference between good secondary property and 'crap' can be 250 basis points. Whether calculating the value of a retail complex in Charleston, South Carolina, a development site in Castleford, Yorkshire, or a multifamily asset in the Mie prefecture, that's the pressure the modern-day valuer must accept. □