The Market Paradigm

Challenges Create Opportunities

By Susan J. Booth

The Federal Reserve took the unprecedented step of lowering the federal funds rate (the overnight interest rate for loans between financial institutions with deposits in the Federal Reserve) by 1.25% during the month of January in an effort to increase liquidity in the capital markets, alleviate fears of an impending recession and bring stability to the real estate market. Although this move is unlikely to provide any immediate relief to California's commercial real estate market, changes in the market paradigm will bring opportunity.

The current credit crunch began early last year when defaults on subprime mortgages started to swell, and an ever increasing number of national and international financial institutions wrote down billions of dollars in subprime losses. Those losses spurred real estate lenders to re-evaluate their residential and commercial real estate underwriting. The re-evaluation had a chilling effect on the capital markets and capital virtually disappeared overnight. A decrease in the federal funds rate can not invigorate the capital markets as long as investors believe that capital will remain unavailable while the subprime fallout continues.

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Additionally, there is no direct relationship between the federal funds rate and the interest rates in most commercial real estate transactions. Most variable-rate commercial real estate financing vehicles contain a floor interest rate and are aligned with the yield on 10-year treasuries or with LIBOR. Therefore, even a substantial reduction in the federal funds rate does not materially affect interest rates in commercial real estate financings.

Over the past few years, Sacramento, Alameda, Bakersfield, Sacramento, San Bernardino and Santa Clara counties, have experienced substantial population growth. Those same areas are now experiencing a marked increase in residential foreclosures, and the downturn in those markets has spread to the local commercial real estate markets. A reduction in the federal funds rate cannot stop this spread. Any consumer that cannot afford to pay his mortgage will not be spending money at a local retailer. Some of these retailers will be forced to close. Others will renegotiate rental rates. The office market will also experience increased vacancies and lower rents but for different reasons. Many organizations related to the subprime industry have shut their doors. Others continue to operate but have substantially reduced their work force. In either case, these businesses (most located in suburban areas) no longer require the space they once did. Vacancies will increase because new business will not fill the void. Businesses are reluctant to implement significant changes, including the acquisition of a property or long-term leasing of space (whether office or industrial), in the current environment. Absorption of excess capacity will not commence until businesses perceive economic stability on the horizon.

The decrease in the federal funds rate has not alleviated recessionary concerns or created a perception of economic stability. The stock market declined precipitously after the interest rate cuts and remains volatile. Wal-Mart is the largest of many national retailers who have announced that its January sales numbers were well below the forecasts, making it clear that consumers are not spending. Congress has passed a stimulus package intended to encourage consumer spending and bolster the economy. In the meantime, investors are evaluating their portfolios and acting proactively to maximize their position because most prognosticators believe that commercial real estate prices in California will continue to decline. People with "workout" skills are in high demand. The vice president at the lender with REO experience, the forensic accountant and the bankruptcy lawyer cannot find enough hours in the day to tackle the challenges they face.

The first step to finding new opportunity is to recognize that the paradigm has changed. The highly leveraged buyer who could "overpay" for a property year ago no longer exists, creating a gap in the expectations of seller and buyer. This gap will start to narrow as sellers accept that it is now a buyer's market. Sellers will once again provide representations, warranties and indemnities, preferring to offer better terms over lower prices. Buyers will no longer be required to release sellers from claims. But it will take more than a change in terms for the market to stabilize. Necessity is the mother of invention, and serious players in the commercial real estate market will invent a new strategy and look for different types of opportunities. In a declining market, stabilized assets do not generate substantial profits. The best means for generating profit in a declining real estate market is to add value, whether through new construction, redevelopment or repositioning. Yet value-added projects bring risk. With a shortage of traditional capital (particularly for risky projects), expect to see more REITs seek equity partners for joint venture developments. Although equity capital can be expensive, the risk/return ratio makes more sense in connection with a value added project. Also expect to see developers contribute real (not just implied) equity to a joint venture. As the investors start operating in the new paradigm, the expectations of sellers and buyers with respect to property values will align, and that alignment can bring success to those who play by the new rules. **CC**

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***About the Author**: Susan J. Booth is the head of the West Coast Real Estate Group of Holland & Knight LLP, which has the largest real estate practice of any national law firm. Ms. Booth handles a variety oftransactional real-estate matters, including secured lending, purchase and sale, workouts and leasing.*