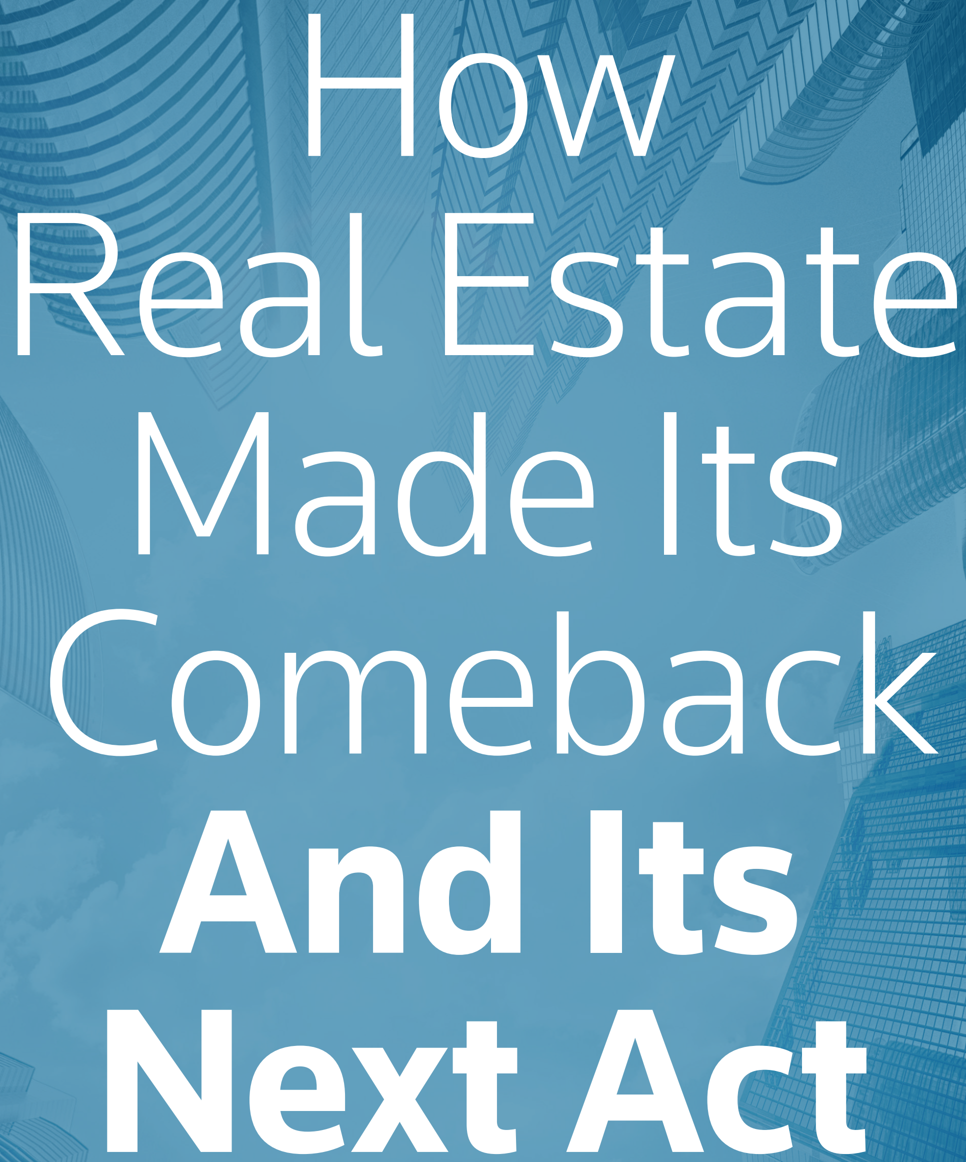
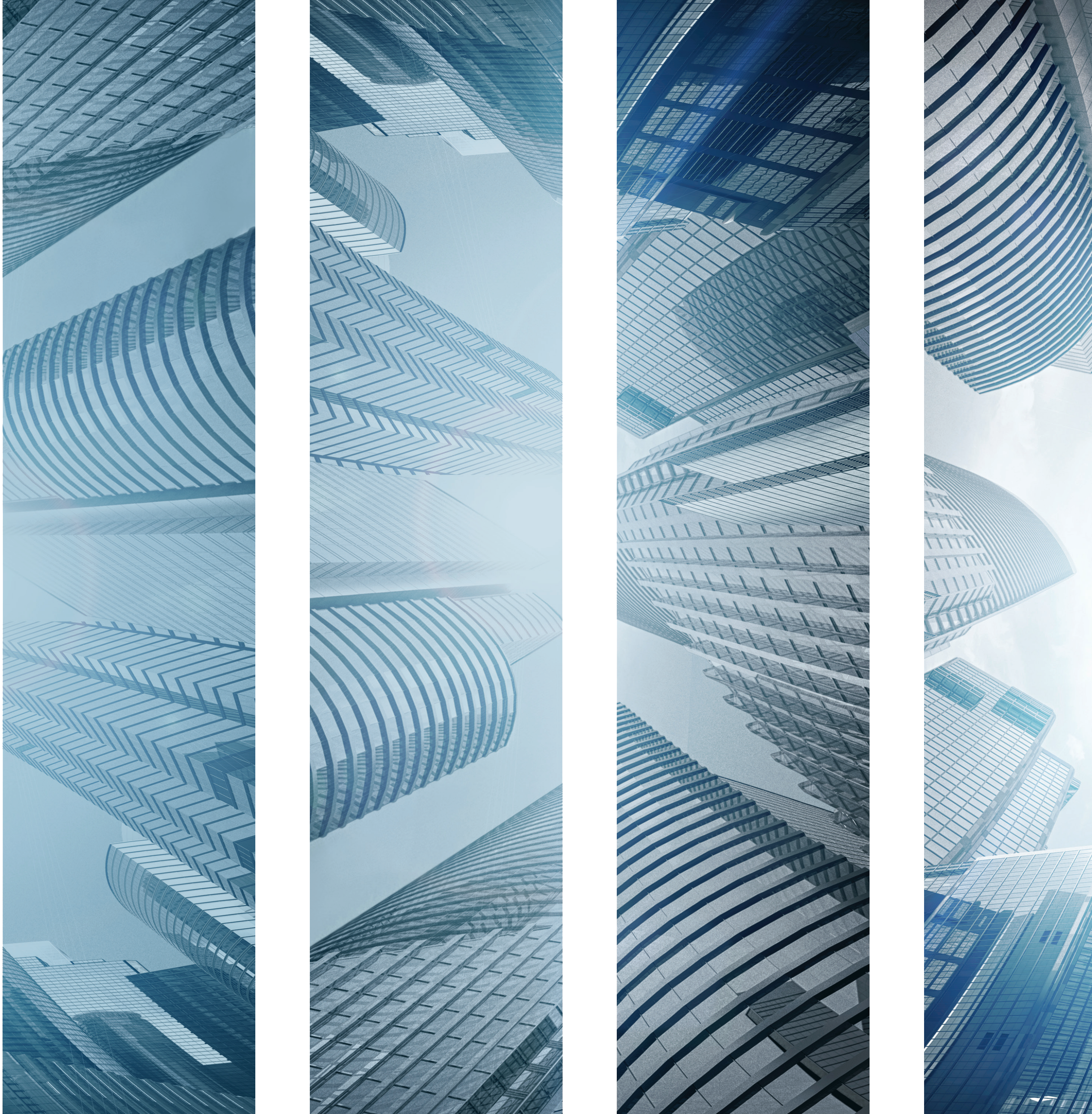


How Real Estate Made Its Comeback **And Its Next Act**

Practical Law Real Estate asks members of its Advisory Board, each a leading practitioner in the industry, for their thoughts on the current real estate boom, including lessons learned during the post-2008 downturn, trends and factors driving the market, and projections for the future.

© 2015 Thomson Reuters. All rights reserved.



©iStockphoto.com/cosmin4000

Much like the broader market, the US real estate market experienced a crippling decline in 2008 and a sustained recession thereafter. In 2015, industry experts generally agree that the commercial real estate market is back and stronger than ever.

This article explores the commercial real estate industry's recent comeback, focusing on how the 2008 financial crisis has shaped legal practice and identifying ways the current market boom is different from the pre-2008 real estate bubble.

2008 FINANCIAL CRISIS

Market participants often say that real estate is the greatest predictor of economic conditions. In early summer 2007, real estate not only predicted economic decline, but played a critical role in the reduction of available credit, often referred to as the credit crunch. By October 2008, the US economy was in a full-blown financial crisis.

This credit crunch was triggered primarily by the bursting of the US housing bubble. Housing price increases had been fueled

© 2015 Thomson Reuters. All rights reserved.

by cheap credit extended to risky borrowers on a massive scale as lenders competed against each other to achieve the best available yield on their loans.

Financial institutions used securitization to pool these mortgages together and issue mortgage-backed securities (MBS) to investors. The MBS were themselves repackaged and bundled together into other securities known as collateralized debt obligations (CDOs). As subprime borrowers began to default on their mortgages, the value of MBS fell and the market for them became illiquid.

By August 2008, financial institutions around the world had recognized subprime-related losses and write-downs exceeding $501 billion, and September 2008 brought a series of market-transforming events, including Lehman Brothers' bankruptcy.

INDUSTRY TRENDS

While the real estate industry has seemingly returned to the halcyon days of pre-2008, current market features put the industry in a different, arguably more secure, position than it had been before the recession.

The market today is seeing an abundance of available capital. Unlike in pre-2008, however, there are much stricter underwriting standards. Specifically, there is a noticeable lack of subprime loans. Lenders are requiring a greater output of equity in deals. Coupled with a low interest rate environment, this has led to a healthier market. While the uptick in market activity cannot be expected to go on indefinitely, many experts believe that because of these conditions, when it does start its downturn, the economy is unlikely to suffer as cataclysmic a decline as in 2008.

There has also been a strong influx of foreign capital into the US real estate market, signifying a confidence in the market and also in the US dollar. Capital is coming predominately from the Mideast, Asia (particularly China) and Canada. While the focus is directed at trophy assets in primary markets, there is considerable capital being pumped into secondary markets and gateway cities as well. Additionally, foreign investors are playing an increasingly active role in managing their US investments, foregoing a more traditional passive role.

Both foreign and domestic investors are showing interest in development across asset classes, including mixed-use, hospitality, retail and office. Additionally, the surplus of available capital is turning investor interests towards historically less popular asset classes, including student housing properties and healthcare-related assets.

THE MARKET'S EFFECT ON LEGAL PRACTICE

For a client, invaluable legal advice is characterized by both seasoned legal experience and sophisticated business acumen. This is particularly true for real estate attorneys, where market forces not only drive business, but very often also impact the way in which attorneys practice law. Therefore, real estate attorneys must have an in-depth understanding of the forces driving the market to successfully negotiate on behalf of their clients' best interests (both in terms of getting the deal done now, and protecting the client if the market turns during the life of the deal).

For example, many experts believe that the 2008 financial crisis would have been much worse, with many more borrowers declaring bankruptcy, had so many lenders' attorneys not insisted on nonrecourse carveout guaranties on their clients' mortgage loan financings. Had these attorneys not required tightly drafted full recourse guaranties, many more financial institutions would have suffered greater losses and the real estate market would likely still be mired in bankruptcy workouts rather than experiencing its current revival.

To further understand the current real estate market and its impact on legal practice, Practical Law Real Estate asked several members of its Advisory Board to share their views and experience.

FOREIGN INVESTMENT IN REAL ESTATE

There has been a recent influx of foreign investment into the US real estate market. What are the types and sources of foreign capital and have they changed since before the 2008 financial crisis?

Stuart Saft:

We are seeing capital coming to the New York City market from Asia, Russia, the Mideast, Europe and South America. It is being used to fund both equity and debt, as well as purchase property ranging from development sites to all or parts of buildings and even individual units.

Prior to 2008, foreign capital invested in the US was predominantly in the form of loans from large and small financial institutions. Now foreign capital is coming from individuals and funds as well as financial institutions, although the financial institutions are playing a less significant role than

Current market features put the industry in a **different, arguably more secure, position** than it had been before the recession.

© 2015 Thomson Reuters. All rights reserved.

they had previously. Obviously the regulatory restrictions that have been in place since the financial crisis have forced financial institutions to take a more cautious approach. Similarly, we are seeing foreign investors wanting to take a more active approach in their investments. They are not leaving it to their US counterparts to act on their own.

Peter Fisch:

Our experience follows that trend, particularly with Chinese and Canadian investments. Other sources of foreign capital are also, but to a lesser extent, investing heavily in the US, as the list of players has broadened over the last few years (with Middle East-based investors quite active).

In recent years, capital coming into the US is not just passive capital. Foreign developers are getting into the act and trying their hand at developing US properties, often in joint ventures with local developers. Pension funds and sovereign wealth funds are probably the most active investors. Direct investment is just the tip of the iceberg, as a lot of additional investment dollars are coming in from overseas through private equity channels.

Andrew Lance:

Foreign investors have had keen interest in investing in US real estate for a number of years, since the real estate market's post-financial crisis recovery became clear and enduring. The economic case for the security of, and the potential appreciation and overall return from, US real estate investments has been compelling since that recovery.

The appeal is magnified by the many attributes that have long made investment in the US attractive across the spectrum of asset types, including sophisticated and deep capital markets, a strong legal system and clarity of rule of law, a stable government comparatively free of corruption, domestic tranquillity and an educated, dedicated and growing workforce. As the world has become more volatile in many places outside the US, interest in investing in the US has increased across all sectors of overseas capital, including institutional capital, real estate funds, high net worth private capital and sovereign wealth funds, and across all geographic regions.

Search Investments in US Real Property by Non-US Investors: Basic FIRPTA Rules for information on FIRPTA rules and compliance.

How is the influx of foreign capital affecting the US market? Are certain regional markets or asset classes (for example, residential, commercial or industrial properties, and core plus, core or value add investments) attracting more foreign capital than others?

Peter Fisch:

The obvious effect of robust foreign investment is upward pricing pressure. Without a doubt, the trophy assets in the primary markets (New York City, Washington and San Francisco) are receiving the greatest attention. An example of this is the recent Waldorf Astoria sale. The focus on those assets has priced many of the secondary foreign investors out of the prime properties in the hottest markets. Consequently, more money is now being deployed on previously less desired assets and in a subset of secondary markets (for example, Houston). As foreign investors begin to seek a little more yield, the trend seems to be a broadening of asset classes and an exploration of value add investments.

Stuart Saft:

The large amount of capital flooding the US market is causing prices to inflate so high that properties that were not previously on the market are being offered at very high prices and at low cap rates. This phenomenon is funding incredibly interesting and very complex transactions.

I am seeing class A and class B properties in New York City being sold for prices in excess of anything we have previously experienced. I also understand from foreign buyers that in addition to New York City, they are also looking for class A and class B properties in other large cities. Other than in Los Angeles, Chicago and Miami, however, I am not seeing the kind of volume we are seeing in New York City.

Contributors

PETER E. FISCH
PARTNER
PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

Peter regularly represents developers, entrepreneurial investors, institutional investors, lenders and other parties in all aspects of transactional real estate, including acquisitions and dispositions, joint ventures, conventional and securitized financings, workouts, sale-leasebacks, management contracts, leasing and investment funds.

ANDREW A. LANCE
PARTNER
GIBSON, DUNN & CRUTCHER LLP

Andrew is resident in the firm's New York office, where he is a member of the Finance Committee and Co-head of the Real Estate Practice Group's Hotel and Hospitality Practice. His clients include private real estate equity funds, hedge funds, corporate and individual developers and owners of office, retail, hotel, industrial, recreational, professional sports and entertainment real estate, mortgage and mezzanine lenders, REITs and other public and privately held companies investing in or using real estate.

STUART M. SAFT
PARTNER
HOLLAND & KNIGHT LLP

Stuart is Chair of the firm's New York Real Estate Practice Group, Co-chair of the Global Hospitality, Resort and Timeshare Group and Co-chair of the Global Condominium Development Team. He has extensive experience in the development, financing, leasing, conversion-to-condominium and cooperative ownership, exchange, syndication, sale-leaseback, timeshare, restructuring, acquisition and sale of residential, commercial and hospitality property throughout the US.

© 2015 Thomson Reuters. All rights reserved.

Andrew Lance:

The depth and breadth of interest in investing in US real estate from foreign capital contributes to sustaining the current strength of the real estate market across the US. While interest initially was focused on marquee assets in gateway cities, interest has expanded from that narrow target to include less pedigreed, but still solid, assets in gateway and secondary cities, across all asset classes and most geographic locations.

Interest also has moved beyond stabilized, existing assets to include not only development opportunities, but also specialized asset sectors such as assisted living, student housing and other special purpose facilities. Hotels and resorts continue to attract separate sources of capital. While in the past offshore investors would invest only with a seasoned and recognized sponsor, investments today are being made with new sponsors with less of a track record, and as direct, independent investments.

Search Hospitality Law: Overview for a discussion of hotel real estate transactions, as well as an explanation of the different management and operational structures of hotels.

THE CURRENT MARKET

How is the 2015 real estate market different from the market pre-2008? Have you seen a shift in negotiating leverage in this latest market boom and which party do you think holds the advantage in each type of transaction?

Andrew Lance:

Financing based on entirely projected (speculative) income is not visible to the extent it was pre-crash, and investors are generally more attentive to structuring for the need to tolerate and bridge potential downturns in the market. Sellers clearly have the greatest negotiating leverage, since the pipeline of available assets is limited and fully priced. An ample supply of capital at historically low rates has diminished the control rights of many capital providers (both as partners and as lenders). In loan transactions, owner-borrowers have significantly greater strength in negotiating terms in the current market.

Stuart Saft:

More diverse players are now involved in the real estate market and large foreign banks are not playing as active a role. Investors are not willing to take a completely passive role anymore. We are seeing foreign developers actively buying and developing properties independently. When not investing directly, foreign investors, who are generally willing to hold onto their investments for longer than their US counterparts, are consequently taking a greater interest in their US partners' management decisions and actions as a way of protecting their US investments. To a large degree the equity is still in control, but since there is so much money around, the operating/managing member has a bit more leverage since it can easily find a different equity player if negotiations on the business terms become too difficult.

Peter Fisch:

While it sometimes seems like we are back to the easy money times of pre-2008, in my view there is a clear difference in underwriting standards by lenders (and owners and operators). I think lenders are much more disciplined than they were prior to the downturn, and much of what is driving the expansion is plentiful equity capital. Lenders are back to requiring significant "skin in the game," especially in development transactions, where we have not seen recent transactions without meaningful principal guarantees. Asset capitalization is also much healthier.

Have the myriad of regulations and incentive programs (for example, the Dodd-Frank Act and federal and state tax credit programs) implemented over the last eight years had an impact on the current market?

Stuart Saft:

The Dodd-Frank Act is just making it difficult for US banks to make loans and for average Americans to obtain credit. It is not having any significant effect on this real estate boom because these deals are less based on debt and more focused on various forms of equity.

Andrew Lance:

We have not seen any of the legislative regulations have any real material impact, other than in incentivizing affordable housing.

Search Summary of the Dodd-Frank Act: Mortgage Reform and Anti-predatory Lending for information on Title XIV of the Dodd-Frank Act.

What types of properties and asset classes do you think are seeing the strongest growth?

Peter Fisch:

Investors are looking outside the trophy office, retail and hotel markets, searching for appropriate investments and acceptable yields. We have recently seen increased activity in non-core office assets and industrial properties, and even student housing properties. Healthcare-related real estate assets are also very hot.

Stuart Saft:

In New York City, the market for mixed use, hospitality, retail, office and residential properties are all strong. We are seeing many office buildings being split into two unit condominiums, with one investor taking the retail unit and the other investor taking the office unit. We are also seeing office buildings being converted to both residential and hospitality investments. In the retail market, we are seeing multiple buyers bidding on deals, which is driving growth.

Andrew Lance:

Residential markets in urban centers and the periphery have remained consistently the strongest markets. Hotels, urban retail and industrial properties are also very strong now, and interest in non-urban retail is strengthening. We have seen considerable activity in partial-interest transfers, principally in class A office properties involving interests that are below the percentage interest threshold that would trigger real property transfer taxes in each jurisdiction. At a time when many owners are looking to maintain war chests in order to act quickly when a rare opportunity arises, these structures allow a capital partner

© 2015 Thomson Reuters. All rights reserved.

to exit a deal or a sponsor to take some equity off the table to be deployed elsewhere.

What advice are you offering your clients to prepare and protect them in the event of another major downturn? Have you changed your approach to negotiating and drafting deals?

Andrew Lance:

Preserving optionality is important, particularly to allow changes in business plans, permit extensions and defer defaults by committing more capital. Deep capital support for a possible downturn, as well as for unforeseen events unrelated to economic trajectory, is essential. Additionally, quick execution is fundamental to success, and having experience is the key to executing quickly without missing critical issues.

We are not hearing concerns about a possible bubble, which we heard before the 2008 financial crisis. The diversity of clients entering the real estate market for the first time, or for the first time in many years, indicates continuing strength in the market and reinforces the enduring appeal of real estate investments. For offshore investors, tax planning and structuring for inbound capital investment and outbound returns is critical, and is a big part of our practice. Whether the work involves Internal Revenue Code Section 892 issues, private real estate investment trusts (REITs) or cross-border tax issues, real estate transactional work has to proceed hand in glove with sophisticated and experienced tax structuring.

Search REITs: Overview for information on REITs and typical tax structures for REIT investments.

Stuart Saft:

The financial crisis was, to a large extent, caused by securitized debt that was based on housing loans, particularly subprime loans. We are not seeing any of that type of debt this time around. We are seeing a tremendous amount of flight equity coming to the US. There seems to be a general consensus abroad that with the world in upheaval, money sent to the US is safe and, even if the investors do not see a great return on investment, they at least know that their principal is safe.

For the first time, I am optimistic because the US dollar is strong, we are energy independent and our unemployment rate is below 6%. This money is fueling the current boom and, unlike pre-2008, it is not based on home mortgages that can never be repaid.

We are building mechanisms into every transaction to deal with a recession so that investors are protected while the economy goes through its usual cycle. We are carefully examining the due diligence and putting advice to clients in writing. Our documentation held up after the financial crisis, so our clients came through fairly unscathed. However, we spent a great deal of time analyzing things that were happening around us and revising our documents to further protect clients in the event of a future downturn.

LOOKING FORWARD

Many real estate professionals seem to believe this recent market upturn will likely last only two to three more years. Where do you think the real estate market is headed, and what will be the major factors either driving or impeding its continued growth?

Peter Fisch:

The steady climb in pricing over the last few years has given me pause, especially with the difficulties of 2008 through 2010 still a recent memory. However, I think the outlook for the real estate market is relatively optimistic. The market fundamentals seem to be strong, and investor and lender underwriting remain more disciplined than prior to the downturn. I also think the recent volatility of the world equity markets and the worries over the Greek debt crisis will only drive more investment dollars to the US real estate market.

Generally, the US markets are presently perceived as being the most stable, with the greatest chance of capital appreciation. However, the softening of the Chinese and European economies is a little worrisome. Additionally, interest rates remain a considerable risk. If interest rates rise to the point where they push cap rates up significantly, the outlook would certainly change. And of course, any other geopolitical shock could hamper further growth.

Andrew Lance:

Global instability and insecurity has helped maintain the US real estate market as the most desirable investment platform in the world. Growth may slow, but as long as individuals and companies do not have a safer investment alternative, US real estate will shine bright. We have been working around the clock for the last two years to help new and existing clients maximize their success in a lucrative, rising market, and the demand seems to be sustained.

Stuart Saft:

I feel that for the New York City market, there are at least five years of strength left. It is important to remember that prior to 2008, there was not much new construction in New York City. Therefore, that market was not as badly affected by the recession and, even at its worst, prices went down only by perhaps 10% and then immediately recovered. New York City did not have the kind of overbuilt situation that markets around the country and the world had, so all the development that we are seeing now is just a drop in the bucket to what is needed.

© 2015 Thomson Reuters. All rights reserved. Use of Practical Law websites and services is subject to the Terms of Use (http://us.practicallaw.com/2-383-6690) and Privacy Policy (http://us.practicallaw.com/8-383-6692).