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2009 market update, forecast: Learn new market rules

The painful reality of the greatest evaporation of wealth and liquidity of a generation is now sinking in.

■ **Home prices:** Values have fallen 15 percent to 50 percent, wiping out homeowners' equity.

■ **Stock market:** Equity investments are down 30 percent to 40 percent (including market portfolios, 401k and 529 plans).

■ **Unemployment:** All sectors are laying off workers, causing a sudden surge in unemployment.

■ **Zombie banks:** Banks are laden with underperforming assets, and TARP has only given them hope of survival. Banks have no incentive to write down loans to clear the market, as they would be announcing that they are insolvent.

■ **Securitization:** The largest, most reliable and accessible real estate liquidity provider, commercial mortgage-backed securities, has evaporated right before our eyes. Our entire industry relied on the assumption that there was a reliable and predictable permanent loan market at 80 percent of value and at 1.25x debt service coverage. Billions of dollars of loans were made on that assumption. Now it's gone.

Future real estate values: It's the one-two punch that is driving down values.

■ **Capital structure changes:** Equity requirements have gone from 10 percent of total costs to 40 percent of total costs. This structural change alone will



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account for a significant decline in value.

■ **Cash flow decreases:** Commercial real estate values depend on cash flows. Declining net operating incomes will

be the "second blow" to commercial real estate values.

Combined, these two factors will cause commercial real estate to decline 20 percent to 40 percent, depending on asset class, market and location.

2009 Market Forecast

This will be a gut-wrenching, shakeout year for the commercial real estate industry. There will be less capital, lower prices and lighter transaction volume. As the year goes on, the federal government will provide clarity on how it will address the "financial crisis."

Our industry will remain in stagnation until the federal government picks a direction, and we all know the new capital market rules.

What's In and What's Out

Whatever choice the government makes, we can clearly say what's in and what's out for 2009.

In: Distressed asset acquisitions

Apartment rent per foot x square foot of space =
Vacancy: Subtract greater of 10% or market vacancy
Expenses: Use a 40% expense ratio

Cap rate: Use 8%-9%

Total revenues
(Less vacancy)
(40% of revenues)
NOI
8.5%
Value of condo

Out: Value-added development plays

In: Nonperforming note acquisitions

Out: New development loans
In: Equity to recap existing projects to meet new equity requirements

Out: Cash-out deals
In: High-yield (hard-money) bridge lending

Out: LIBOR plus 250
In: Workouts
Out: 90 percent acquisition loans

In: Underwriting declining property performance

Out: Underwriting increasing property performance

Underwriting in a Down Market Environment

The only land that has value today is finished lots. Finished lots are being bought for 50 percent to 75 percent of the cost. Therefore, today platted lots have no value. Only long-term, very patient investors can invest in platted land.

Condos should be valued at their apartment value.

A quick valuation method:
Commercial asset investing over the next two years will be driven by two basic metrics:

Investor basis in the asset:

This is typically measured in per square feet, per unit, per door. Investors will seek to have their cost basis below replacement cost. A low basis will allow the investor the ability to lower rents and still be able to achieve an acceptable return on equity.

■ **Cap rate to investment basis:** This is the same as the cap rate if the investor is buying an asset fee simple with *pari passu* equity. This metric is higher (better/safer/more yield) if the investor is entering the deal as preferred equity or as participating debt.

Investors will calculate this metric on an unleveraged basis, and on forward-looking, downward-trending "market" assumptions such as lower occupancy and lower rents. Investors will be looking for unleveraged yields of 10 percent to 12 percent, depending on the asset class and the market. This will be achieved via: distressed/opportunistic purchase price; subordinate seller financing; and investors entering a deal either as preferred equity or participating debt.

As the commercial market continues to evolve, the above metrics will be the key to the "go/no-go" question.▲