A New Breed Of Investor Is Bringing Valuable Skill Sets To CRE Assets

After witnessing the escalation of real estate prices and a compression of cap rates, investors are turning to a strategy of adding value.

BY W. JOSEPH CATON

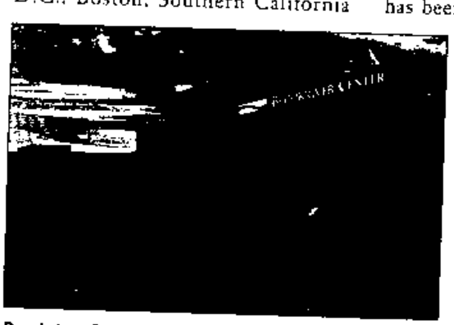
With the now well-coined phrase "irrational exuberance" quickly becoming a part of the daily vocabulary of commercial real estate finance and investment professionals, there is little doubt that the prices being fetched for today's properties are well above what many market forecasters would have predicted a few short years ago.

The current raging commercial real estate boom has truly been a surprise. Higher and still rising interest rates were broadly forecasted to have hampered further price growth and to have caused investors to pull back from the sector by now. But the market has defied all odds, and continues to move forward. For example, prices of some assets in hot markets like New York City, Boston and Washington, D.C., are fetching values that have tipped the high-end scales as high as $700 per foot and are realizing sub-four capitalization (cap) rates.

Driven by tenants-in-common (TIC) and 1031 exchange investors, today's market has seen cap rates at unthinkable lows and has been treated to unprecedented premium bids from buyers who must have the deal. Lenders continue to report stiff competition for deal financing transactions as well, with borrowers demanding (and expecting to receive) higher leverage and more lender concessions. Most lenders have now engineered methods of structuring deals to meet borrowers' demands for higher leverage, even in the face of lower property cash-flow fundamentals and generous debt service coverage allowances.

Short-term cash-out refinancing has also been driving the most recent crop of high-leverage deals, particularly as Wall Street firms and the capital markets have weighed in by making cheap capital available for commercial real estate investments. There is no doubt that the excess of capital, similar to what drove the boom of the dot-com era five years ago, is beginning to rear its ugly head capital is doing so in the real estate market. To this end, many observers - including some financial markets regulators - are becoming concerned about the apparent lack of market discipline in this space.

In the midst of this headline-driven frenzy, a quiet group of property investors has emerged. They are investors who have been paying close attention to the super low cap rates and the record-high price-per-foot numbers in major metropolitan centers like New York City, Washington, D.C., Boston, Southern California and south Florida. These are the diligent real estate investment and property management professionals who bring a new line of skill sets to the commercial real estate investment table - skill sets that are often overlooked in the food fight for prized properties, prime locations and the hottest new asset type of the day.



Brookriver Executive Center is a 312,000 square-foot office building located at 8200 Brookriver Drive in Dallas. The seven-story property is just 28% leased. Over 11 months of holding, Younan Properties Inc. achieved a 100% return, despite a 2% drop in occupancy, by reducing operating expenses from $3 million to $1.2 million.

Value-adding investors, while they have always existed under the radar screen, are a group that many industry players (such as cautious lenders and equity partners) would like to identify and do volumes of business with. The group is often absent from the limelight of mega-deals and complex structured debt and equity financing transactions. These investors represent in the industry today. They stand clear of high-priced assets, with an eye on rising rates and slowing cash flows from high-priced properties. With this strategy, value-adding investors are prepared to rise above the foray of inexperienced/passive investors who are willing to settle for lower commercial real estate investment returns than seasoned institutional investors would.

As a case in point, the third-largest office property owner in the Dallas metropolitan area - a market which has been experiencing a dismal 35% vacancy rate for the past few years - is Woodland Hills, Calif.-based Younan Properties Inc. The company has been making acquisitions in parts of that submarket, as well as other subperforming cities such as Chicago and Phoenix, with a business plan to manage inefficiencies in these underachieving assets and their overlooked regions.

To be sure, investing in a market like Dallas requires a certain level of strategic property management and operations risk mitigation that would gain the attention and trust of any lending and investment institution. These risk management skill sets are at the heart of the strategy for making deals in those subperforming markets work well for all interested parties.

In fact, many of the larger, publicly traded real estate investment trust (REIT) institutions have been net sellers - by rotating out of these properties for some time now. They are giving way to this new breed of investor who is stepping in and making these assets work.

"We have seen several opportunities to buy subperforming assets in these markets and to work on what we do best - finding inefficiencies," says Zaya Younan, president and chief ex- Inc. "We have often been shocked at how much inefficiencies we can uncover and how much operational cost savings we can achieve, even in assets that we have acquired from national institutional investors."

Zaya Younan

Younan says that his company's strategy of buying underperformers - while quite appealing to investors who are looking for higher investment yield - can be a trap for inexperienced investors who find themselves chasing yield in a market frenzy and looking to turn over investment properties in a hurry.

"Lately, we have been noticing a very unusual development among the lenders we work with," says Younan, whose company often works with Countrywide Commercial Mortgage to fund its deals. "We have noticed lenders now asking more and more questions about things like the potential cost of janitor services, building surveillance/security contracts and negotiations for maintenance supplies."

Younan says that he is encouraged by this new development because it signals the long-awaited turn of events in which lenders stop lending based on the asset only, and start lending on the basis of the sponsor's ability to make a particular property work. He says that it is a very good development that lenders are beginning to pay more attention to who will be managing the asset and that manager's ability to make highly leveraged numbers work for all interested parties.

A new culture

"We had been using third-party property management services in our business model for years and found that we were bumping up against a different culture than the one we promote internally," explains Younan. "We began to notice that while the ...

consistent with the culture of cost efficiency we have been successful with.

Younan says that his company made the decision to take all of its building management activities in-house about six months ago, after it acquired a number of properties that required very tight control of operating expenses in order to make lenders comfortable with the company's deals. He feels that it was a perfectly logical choice because it now allows his staff to drill down into the details of operations, where he has discovered the greatest amount of inefficiencies and opportunities to add value.

According to Younan, this culture helps his property management staff to better navigate the events that directly affect the profitability of each asset, as well as the organization itself.

"When you consider the fact that every dollar of cost savings you can achieve by finding and eradicating inefficiencies in your building's expenses goes straight to the bottom line, why would you not take hold of that process?" Younan asks. "I don't think that the institutional investors that we buy subperforming buildings from are any less capable of profitably managing buildings than we are. They are just used to the assets being run a certain way, and they are either not prepared to or not able to change those processes on a dime."

Younan says that the institutional investors have a business model that includes managing properties in a manner consistent with their capital and debt structure, and he admits that it works very well for them and their shareholders. However, Younan is convinced that as the current run of rising prices comes to a head, there will be a rush to get back to the basics of controlling cost in the operation of real estate assets, and he plans to place his organization at the forefront of that culture.

Value-based lending

Gregg Winter, president of W Financial Mortgage Fund I LLC, a New York City-based direct private mortgage lender that specializes in value-adding property finance, has taken note of the new breed of investor that Younan represents. Winter notes that his group - which is also affiliated with a commercial mortgage brokerage shop, New York-based Winter & Company Commercial Real Estate Finance - recently arranged a $19 million construction loan for a unique loft-style condominium development on the Upper East Side of Manhattan.

The 10 loft-style units will range from 2,500 square feet to 4,900 square feet. Because the development is a gut renovation of an old garage building, the time frame will be more complex, and so the structure of the credit facility allows the borrower to fix the rate on a portion of the loan and float the rate on the balance," says Winter. "The credit facility is coterminous with an existing $16.5 million first mortgage and will provide the needed funding for a series of major capital improvements."

The loan was structured at a rate of LIBOR plus 225 basis points, and will permit an additional $3 million of mezzanine financing to be provided by W Financial Mortgage Fund I.

In addition to its focus on the New York City metropolitan area - and the U.S. East Coast market in general - Winter & Company Commercial Real Estate Finance has been looking at transactions in the subperforming markets of Illinois and Arizona, where value-adding deals can still be had.

"As an example, today we are seeing lenders begin to chop back on doing loans for the development of many new condominium projects in certain markets," says Winter, who is looking to expand business with the new breed of investors and property sponsors that can find value and manage properties under adverse market conditions.

"And we are now noticing that lenders are asking a lot more questions about the viability of a project and the level of commitment that a sponsor may have to a highly leveraged deal," he says.

Gregg Winter

"Up until recently, lenders would consider deals on the basis of potential property value above all else. But now, the ability of a sponsor to profitably pull off a project has taken over as the overriding concern."

Winter mentions that in the south Florida market, for instance, where prices have grown at an astronomical pace, the number of deals that lenders are seriously looking at has begun to drop off. He believes that weak sponsors and weaker projects will be forced to present better fundamentals and low funding prices to get the interest of some prudent lenders.

At the same time, Winter is still bullish on a market like New York, even though it is one of the richest markets in the world today. He has determined that even though some of the highest prices are being realized in that market, the fundamentals are far better than other high-priced places he has been studying.

"A market like New York is differ-

29 Gallatin Place is currently the unused portion of the flagship Macy's department store property in the heart of downtown Brooklyn, N.Y. The Treeline Companies will undertake an extensive redevelopment of the property to produce approximately 100,000 rentable square feet of Class A office space.

the acquisition costs that investors must pay, you have to also consider the quality of demand for space across the entire spectrum of property types."

He says that the condo market in the New York area, for example, is far from being overbuilt compared to other parts of the country, where cheap capital has attracted a host of new and inexperienced developers to the space.

North Central Plaza is a 16-story tower at Dallas' second-busiest intersection - the southwest corner of the LBJ Freeway and North Central Expressway. The 346,575 square-foot building was recently acquired by Younan Properties Inc.

Younan refers to the rush by these new and inexperienced investors to own a piece of commercial real estate as the "herd mentality" that will likely become a problem for lenders and investors alike down the road.

"When you consider the pressure that some TIC- and 1031-exchange investors are under to turn deals over, in order to preserve their favorable tax treatment," says Younan. "That would definitely explain why they are stepping in and paying the richest prices around. It does not, however, justify the poor metrics associated with many of these purchases."

Younan says that he rarely gets into a bidding competition with TIC- and 1031-exchange buyers because he believes an investor would have to pay a great premium to beat out these buyers for just about any property in any market, including a subperforming market like Dallas.

Younan Properties was able to achieve a stunning 100% internal rate of return (IRR) on the disposition of properties in the Dallas market, and Younan attributes the success to the company's business model of going into an asset and achieving cost savings that go directly to the bottom line.

The company recently achieved that 100% IRR on the disposition of three Class B office buildings totaling 600,000 square feet. The three properties made up the $27.5 million disposition transaction of the company's Stemmons Freeway Corridor portfolio, and that return was accumulated upon a year-to-date average leveraged IRR of 65%.

"We entered the challenging Stemmons submarket two years ago, in the