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Opportunties in 2006: The capital markets are flush with cash to both lend and invest

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What? Where? Why? Like stocks and bonds, private real estate investing requires good insight, research, and sometimes luck. Unlike stocks and bonds, private real estate doesn't price every day and therefore is less efficient and creates opportunities. From our vantage point at Tremont, we see both the real estate equity and debt capital view as follows:

Office – CBD - Positive - Most markets are recovering with lower vacancies and evidence of rent growth due to the lack of new construction in the recent past. Gateway cities (Boston, New York, Washington DC) have always been in favor and continue to show strong interest among lenders and investors. Secondary markets in smaller MSA's (metropolitan statistical areas) are also in demand, since the lack of boom/bust cycles in these markets generally enables them to chug along at slower pace. The proliferation of the Tenant-In-Common (TIC) industry has added significant liquidity to these markets as well. Returns are generally in the core range in this segment

Office – Suburban - Increasing Interest - Vacancies are dropping and the prospects for rent growth are on the horizon. Buyers will pay sellers now for vacancy which lenders will now finance. Business plans on these acquisitions generally run for 3 to 5 years to stabilize and then look for a capital event to either sell or refinance the asset. The increase in short term interest rates and construction costs have made repositioning plays a little riskier than a year ago, however this has been mitigated to some degree with better market fundamentalsand rent growth expectations. Returns can range from enhanced core to core plus returns.

Residential – Multifamily – Strong Interest –This is due to the heavy conversion rate of existing units to condominium and current higher interest rates forcing many potential buyers to consider renting, there is great appeal for both acquisition and development opportunities in this asset class. A trend toward transit-oriented development (TOD) has achieved easier re-zoning and higher densities and sometimes public assistance on infrastructure costs that can add to the project economic benefits. Rental development projects, though generally less profitable than a condo project, are much easier to capitalize since they appeal to a broader segment of the market. Debt and equity yields on this asset class are generally the lowest of any other group.

Condominiums – Proceed with Caution – Conversions and developments are still getting done, however it's harder than it was a year ago. Oversupply, higher interest rates, and increased construction costs have made these investments more of a challenge. Projects that can underwrite to apartments on a downside basis and can be phased are more inclined to make it to the closing table. Others that don't fit this criterion can get done, but will require compelling factors including location, sponsor, and credit enhancement among others. Investor and lender interest in these projects is highly segmented based on whether the project falls in the entry level, moderate or luxury end of the market.

Retail – Strong Interest – Open air lifestyle and power/grocery anchored centers are in high demand. Cap rates and spread pricing are at their lowest for this product type. With the consolidation occurring in department store chains, look for more mall conversions to open air centers and/or alternative uses (back office, call centers, etc.). The recent trend to develop residential around these centers enhances the value of both by offering a much needed 24/7 dimension. With many municipalities under financial duress, rezoning and permitting for this change-in-use has become a little easier due to the economic (tax) benefits they bring to the town as well as a modest impact on traffic.

Hotels – Increased Interest - Both limited and full service hotels are enjoying their best occupancies and room rates since the 9/11 terrorist attack. As a result, transaction activity both in acquisition and in lending has picked up considerably, strengthened further by below-replacement cost pricing. There is an increased consolidation occurring in the full service end of them market as can be see by the number of portfolio deals being done by Wall Street and large opportunity funds. The branding and increased market share as well as the economies of scales anticipated in these consolidations should produce enhanced yields for these funds.

In summary, the capital markets are flush with cash to both lend and invest in real estate. Banks, credit companies, and insurance companies along with Wall Street (CMBS) all are expecting increased volumes over 2005 levels in the debt area. With the expectation for increased interest rates, lenders are typically more conservative in sizing their loans despite generally improving market conditions. What may have been an 80% loan-to-cost financing a year ago has shifted back to a 75% or below loan-to-cost today. As a result, the growth of mezzanine debt and preferred equity is expected to fill the gap. These subordinated debt and equity investors include opportunity funds, pension funds, private syndicators and more recently hedge funds. Hedge funds, in particular, have made a big impact on asset classes that are typically out-of-the-box for most other institutional investors. These include interest in land, resort, and time share/fractionals investing in both domestic and international markets.

Depending on your risk/return profile, the above asset classes can: offer attractive yields compared to alternative investment options, diversify your portfolio, and enjoy participation in a private market and capitalize on its inefficiencies.

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