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REPORT

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AFTER THE FALL

Even as the myriad of financial events that make up the recession continue to unfold, it is not too soon to ask how commercial real estate will be transformed by the process. Many observers have suggested that the current downturn differs fundamentally from others since the Great Depression. Honest people can disagree about its causes; some say it was the predicable outcome of unfettered ''animal spirits'' turned loose in a high-tech transaction environment. Others believe it was caused, at least in part, by a bipartisan and well-intended urge to expand homeownership. In any case, the fallout is a reality that virtually the entire world must sort through with no assurances that the recession will end soon or have no further repercussions than those already in evidence. Commercial real estate has become a major focus for policymakers and industry participants seeking to prevent the worst possible outcomes and to set the stage for recovery. The question posed here to the Real Estate Law & Industry Report Editorial Board delves into the perspectives of professionals whose years of experience in the field number in the hundreds.

Looking Ahead to a New Era in Commercial Real Estate After the Recession Ends

QUESTION: Do you think this recession will run its course and that the commercial real estate sector eventually will resume business as usual? Or have circumstances for CRE changed fundamentally, and if so, how will the industry be different going forward?

Jay Epstien, Editorial Board chairman and partner at DLA Piper US LLP

We all know—or should I say, we all assume—that real estate is a cyclical business. We have seen the ups and downs of the cycle during the past 30 plus years in the contexts of geography—global, national, regional, local—and asset class—hotel, retail, office, multifamily, single family. So, while this cycle that we are in today surely will run its course and there will be a ''recovery'' in the real estate markets, the real question is what will the real estate business look like when we step back through the looking-glass and reach the other side?

In the near term, the other side of the looking glass surely will have some dynamics that are different from those we experienced in earlier recoveries. Most importantly, the systemic change to the financial markets that has and will continue to dramatically affect the way in which the former investment banks did business is sure to have a major impact on the ability of entrepreneurial real estate companies to complete transactions.

While there is indeed much capital sitting on the sidelines, without the fuel supplied by the investment banks that created highly leveraged transactions, the deployment of that capital is likely to take a more conservative, less leveraged path for the foreseeable future. But, if the past is to be prologue again, we should recall that memories are short and the creative minds that drive the industry and the financial markets will find a way to supply the capital that drives much of the deal activity which defines the success of the real estate industry. So, the only question that remains is the one that Wharton real estate finance professor Peter Linneman and others have identified—the biggest variable is the unpredictability of timing of the recovery.

Phillip Nichols, founding member, Pircher, Nichols & Meeks

When the recession has run its course, the commercial real estate sector will in fact resume business as usual, subject, however, to the following:

1. In terms of cap rates and availability of debt, the world will be more like 1996 than 2006.

2. On the buy side, the types of players will largely remain the same: real estate opportunity funds (both closed end and open end), publicly traded real estate investment trusts (REITs), pension funds, insurance companies, and some foreign investors.

3. On the sell side, there will be a major new player: owners of loans secured by real estate. For the next three years or so, lenders will be sellers of real estate—either direct sales of real estate owned properties by the lenders, ''short sales'' by the borrower where the lender accepts a discounted payoff, or sales by lenders of ''loans to own.''

4. As to sources for new loans, there will be some important shifts especially as to securitized commercial mortgages, where I suspect some loan originators will be required to keep some ''skin in the game'' instead of laying off 100 percent of each loan originated.

5. There will be a substantial number of individual casualties, especially among banks, developers, and certain real estate investment trusts.

Leo Pircher, founding member of Pircher, Nichols & Meeks

The recession will run its course and the commercial real estate sector will resume business as usual. As a result, the industry will likely suffer another meltdown within another 10 years. The constants in the real estate business are greed and an apparent inability to learn the lessons of the past.

Learning From Old Lessons. The problems resulting from unrealistic projections, inattentive lenders, overdevelopment, and overleveraging are an old story, which each generation of real estate executives seems to have to learn anew.

But how we are going to emerge is really hard to say. REITs are around to stay but what we're going to do about the securitized market and how it's going to take shape or get replaced—it's really too early to predict.

RICHARD GOLDBERG, SENIOR COUNSEL, BALLARD SPAHR

The early steps following the current recession will be conservative as they were following past recessions. However, the lessons from this recession will be forgotten when sufficient money becomes available, and a new round of excess will then begin.

Joseph Fries, counsel, Arent Fox LLP

At some time in the future commercial real estate transactions will increase as:

1. Substantial amounts of existing CRE will be sold by foreclosure of senior or junior financing at prices that reflect a more sensible valuation of CRE risks and rewards than what prevailed prior to the current financial crisis, and/or;

2. The demand by users (tenants) of CRE for space absorbs existing available and usable space.

New Realities in Pricing. However, there will be a new reality in the pricing of CRE transactions that will reflect a wider spread in the projected rate of return for CRE investments from that of fixed income investments. Pricing will reflect the fact that investors need to include in their cash flow projections assumptions about periodic economic downturns and greater risk of loss of a tenancy due to a business failure even in a good economy. Also, investors must appreciate the need for periodic reinvestment of additional funds for tenant improvements and leasing commissions, renovations, or functional changes that are more conservative than those used (or ignored) in the past.

Eugene Pinover, partner, Willkie Farr & Gallagher LLP

I think that when the current recession in the general economy has run its course, it will be a year or more before we will see normalcy in the commercial real estate markets. The fundamental problem we confront, in addition to the usual issues of slack demand for space following a recession, is that the banks that once provided loans to the real estate industry will need to create a great deal more capital before they will return to ''normal'' lending.

The securitization market is all but moribund and will remain so while Wall Street figures out a new method for originating and selling these loans. This will no doubt start with relatively simple securitization pools that will be relatively small and take time to regain their footing. The game will be changed for a considerable period of time.

Richard Goldberg, senior counsel, Ballard Spahr

I don't think it's going to be business as usual. I'm not quite sure what business as usual really means. After the last major recessions—1987, '88, and '90—when we resumed it was not business as usual because we had a

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securitized market; it was invented. REITs, which were a particularly unpopular way of doing business, became very, very popular.

The last downturn was not quite as profound as what we are facing today; it wasn't business as usual in the context of how we responded to providing funds and credit. It became business as usual and people starting building things, and instead of an oversupply of real estate, it became an oversupply of capital and we started going through cycles that were slightly different.

But how we are going to emerge is really hard to say. REITs are around to stay but what we're going to do about the securitized market and how it's going to take shape or get replaced—it's really too early to predict. A lot depends on government regulation and a lot depends on the appetite for real estate risk of the major players in the market. I don't think any of us have seen a downturn for real estate that's been quite this profound. Certainly not in my lifetime and I've been doing this for 45 years.

Return to Equity. There will be a replacement, I just don't know what form it's going to take. For example, in the great downturn in the 1970s, equity became the inspiration, and there was much more equity than debt. Investors were inclined to go into equity. When 1987 hit—a response to the 1984 tax law changes—equity became an unpreferred form of investment . . . people were no longer interested in equity . . . I think that maybe that's one of the things that we'll see revived. A greater interest in equity.

Joseph Forte, partner, Alston & Bird LLP From my perspective the commercial real estate market is just now approaching the edge of the cliff. While I am not quite sure which trophy property default will be the first to go over, I have no doubt whatsoever that there will be an ensuing avalanche of defaults (possibly approaching 10 percent of outstandings). There is still an enormous amount a bloodletting to occur in the B-note and mezzanine categories before we can get to the mortgage losses.

At present no one trusts valuations of properties or loans; and the lack of transparency in the market is causing significant hesitation. When the residential crisis is under control and unemployment trends reverse, then the commercial real estate market will have a basis for recovery. Although upcycle amnesia always blots out downcycle resolutions to return to fundamentals, there will be some lasting reverberations from this debacle. With it being such an enormous source of capital for the commercial market, the return of CMBS will inevitably occur but when and in what manner is open to speculation but not to definitive answers until the turmoil clears.

Joshua Stein, partner, Latham & Watkins LLP ''It's different this time.'' I'm starting to hear that phrase again when people talk about today's real estate disaster. But it never really is different this time. I remember during the 1991/92 real estate depression, a commentator said something like: OK, we're done with real estate now as an investment class; it'll just be a place where people live or where people rent space. It's not going to have wild appreciation or volatility, and people aren't going to get rich from real estate, either residential or commercial. And of course the world around us at that moment in 1991-1992 suggested the commentator was obviously right.

No one was very interested in real estate. About that time I wrote an article saying now that the real estate boom is over, real estate is just going to be part of the asset pool on larger non-real estate transactions, and here are some good techniques for serving that new world of real estate.

Misplaced Pessimism. Of course the pessimism (and the finality and certainty that travelled with it) was wrong. Real estate did come back, driven by securitization and low interest rates and, in residential, continued and ever stronger policy decisions to favor home ownership over renting.

I do think real estate will come back again; it always does; people always need land and buildings. The question is when it will come back, and how strong, and how long it will take.

I could see the market trundling along the bottom for a couple of years before you start to see any appreciation. People are pretty down on real estate—a lot of people got hurt very badly this time around—and prices are going to take time to stabilize and then start to increase.

What will drive the appreciation this time? Last time it was low interest rates and securitization. Certainly securitization could ''come back.'' It is a perfectly reasonable way of financing real estate, but maybe it got ahead of itself in some ways and there were some built-in modelling assumptions that were overly optimistic. A lot of bond buyers took big hits as a result and won't come rushing back, but at some point I could see them coming back.

Of course, when securitization and other forms of real estate finance do revive, there will be some differences this time around—more discipline (at least for a while), requirements for originators to hold more of their deals, maybe more transparency, simpler documents. It's also fair to expect more regulation.

But it's not as if we have had a regulation-free environment for the last couple of decades. All of our existing government agencies didn't do much to head off our various crises, and in fact in some ways helped contribute to them.

Maybe someone will come up with a Big New Thing in structuring the ownership and financing of real estate, which really haven't changed all that much for a long time.

Perhaps there's a way to fundamentally rethink how people invest in and use and occupy real estate. For example, our traditional bright-line distinctions between ''equity'' and ''debt'' and between ''ownership'' and ''security for a loan'' might not make sense any more. Maybe a third-party custodian/trustee should own real estate, and give each stakeholder—including the ''equity''—a set of contractual rights such as those you find in any intercreditor agreement. Get rid of the notion that someone ''owns'' the asset and someone else is trying to ''terminate ownership rights'' when a ''loan'' goes into default. Just give each stakeholder a set of rights and, if they miss their payments for a certain period, they lose their rights, which travel to someone else. This is kind of like securitizing all the interests in a building, as opposed to just the debt. Why not?

Rethinking Tenant Improvements. Another part of real estate to rethink might be tenant improvements. They are expensive, burdensome, disruptive, and definitely not ''green.'' It's quite wasteful to rip out all tenant improvements every time a new tenant takes occupancy. Architects and developers might devise ways to build more flexibility into space without the need for all the demolition involved in tenant improvements. For example, very flexible, movable walls and building systems could be structured in ways that permit space to be reconfigured at any time without significant expense or disruption.

Perhaps there's a way to fundamentally rethink how people invest in and use and occupy real estate. For example, our traditional bright-line distinctions between "equity" and "debt" and between "ownership" and "security for a loan" might not make sense any more.

JOSHUA STEIN, PARTNER, LATHAM & WATKINS LLP

Because tenants have the upper hand in the market right now, perhaps they could exert pressure to move away from long-term leases and toward a more flexible way for users to meet their needs for space. Today we force space users to pay for occupancy for relatively long periods based on hard calculations of their space needs over five or 10 years. Guessing wrong can be very expensive.

Tenants might move toward much shorter-term occupancy arrangements. They would have more flexibility, but they also would run the risk of market fluctuations. That kind of a change might mesh better with the volatility of staffing and business structures out in the larger world.

My guess, though, is that notwithstanding my various suggestions above, nothing about real estate will change very much, and the industry will come back more or less as it was once people mend their wounds. Real estate isn't going away; once participants become comfortable with pricing and the stability of revenue streams, they will recognize there is money to be made (albeit from a new, lower pricing point).

Real estate investors will use less leverage and deals definitely will be simpler. Developers will have a broader focus on different asset types and market levels, as opposed to just high-end assets for high-end buyers and occupants. In terms of deal structuring, you will see a few more moves in the chess game between borrowers and lenders. The General Growth Properties decisions represent one move in the game; the industry will be eagerly waiting to see how lenders respond.

The industry probably will not fundamentally rethink how one owns or occupies commercial real estate. And eventually we will have another boom and another bust after that.

On a policy level, Washington needs to rethink government's role in all this, particularly on the residential side. Fannie Mae and Freddie Mac own or guarantee half the residential debt that exists. So they ended up bearing the primary exposure to a market meltdown. Basically the Treasury and the taxpayer (the Fannie/Freddie backstop) owned the major part of the risk of secular market declines. All our booming housing values turned out to be just another expensive program sponsored by the federal government. I'm not sure it makes a lot of sense to put the government in this position, and policymakers might want to rethink it as part of the general rethinking that we are going to see.

Ambiguous Government Role. More broadly, today there is ambiguity about whether the government will step in to "protect" any victim of a market downturn, even in commercial real estate. Clarity on this point would be in order.

Deposit insurance is another side of the same coin. It puts on the government's shoulders the risk of widespread collapse in real estate values, as well as widespread exercises in bad judgment (or excessive risk taking) by bankers. Meanwhile, if the risks pay off—or at least don't blow up before the end of the year—the bankers get huge bonuses. The FDIC could be well advised to get back to basics in deposit insurance, so that insured institutions run their real estate financing activities in a very low-flying, low-risk, low-reward, low-leverage way. You would think we had learned that lesson after the debacle of the early '90s.

As a final thought, given that we live in such an era of caveats and warnings, all of the above comments reflect my personal views, and not necessarily the views of any organization with which I'm affiliated or any clients. And it is entirely possible that I will be proven wrong or otherwise change my mind at any time.

Gil Menna, partner, Goodwin Procter LLP I think that the real estate debt capital markets, and in particular, the CMBS market, is going to take some time to recover. We won't see a re-visitation of the boom years level of activity for quite some time.

We will be going back to pre-2003 and 2004 debt underwriting for commercial real estate, which I think is actually positive for the industry. It will take a long time to work out the current stress in the marketplace. In short, we will not see another real estate asset bubble for a very long time, perhaps a generation or longer.

There is a direct correlation between what we saw in cap rate compression and debt availability such that the availability of covenant-lite, inexpensive debt obviously drove asset values higher and reduced cap rates. So I think we are going to just be resuming a more normal course like that prior to this recent run-up in debt availability and easy credit, which, again, I think is healthy for the real estate industry as a whole.

Robert Ivanhoe, chair, New York Office, Greenberg Traurig LLP With the severe downward repricing of real estate assets, decline in operating fundamentals, and complete chaos and lack of liquidity in the financial markets, I would think the recovery from the real estate downturn will be slow and painful. As real estate is, in general, a trailing indicator of the general economy, I don't think we have yet hit the bottom on valuations, and until the economy improves significantly and some material liquidity returns to the real estate sector, I would not anticipate any significant improvement.

I believe this could well take several years, particularly given the increasing maturities of CMBS loans over the next few years, which will peak in 2012 with dramatically insufficient sources of capital available for refinancing, even after the small, short term infusion through the Term Asset-Backed Securities Loan Facility

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for newly issued CMBS securities. I think we may be in for a rough ride in the real estate industry.

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