



September 5, 2007

Written by [Mark Heschmeyer](#)

Arbitrage Can Be Fun

Current Market May Be a Good Time To Crunch Numbers, Spot Investment Opportunities Available in "Overreaction" by Credit Markets

The headline, a T-shirt slogan that was popular among business school graduates in the 1970s, comes to mind after reviewing new commercial real estate market analysis from Principal Global Investors and Raymond James & Associates.

As the markets react to troubles in the housing and credit markets, property, CMBS and REIT prices may have retreated too far, making for a good opportunity to gain on price stabilization.

In its report, called *The Global Credit Market Meltdown: Implications for U.S. Commercial Real Estate*, Principal Global argues that the public financial markets have overreacted to problems in the credit markets and asserts that now is a good time for long-term investors to buy - provided they can identify quality individual investments that have suffered unduly from broad-based price corrections.



(Editor's Note: Just what are those quality investments? We'd like to hear from you and as we do, we'll update the story throughout the day. Are we seeing a return to core properties away from value-added opportunities? Tell us what you think. E-mail me at [Mark Heschmeyer](#). Read excerpts from pertinent follow up comments at the end of the story as they are added.)

"This includes the opportunity to selectively acquire CMBS bonds at historically wide spreads to Treasuries and that provide greater premiums than are needed even under a stressed default and loss scenario," Principal Global reported. "In addition, the market turmoil has provided an opportunity to acquire shares in publicly traded REITs with strong management and high quality, well located properties at steep discounts to underlying net asset value (NAV) of their properties."

Paul Puryear, director of real estate research for Raymond James, noted the same phenomenon in his Fall 2007 Real Estate Market Review.

"From a commercial real estate perspective, the REIT stocks are discounting an expected increase in cap rates driven by a higher cost of capital," Puryear wrote. "Over the past several years, the demand for investments drove the cost of capital for commercial real estate to modern-era lows."

"Although commercial real estate fundamentals are generally healthy and we have yet to see a back up in cap rates on high-quality assets, it is generally accepted that the turmoil in the credit market and increased debt spreads will drive cap rates higher in certain markets and across some assets," Puryear continued. "However, despite some pressure on the cost of capital, we think the public market has overestimated the eventual impact from the turmoil in the residential market on commercial real estate. The stock market has discounted a massive pullback in commercial real estate values, and traded REIT



Commercial Real Estate Services, Worldwide.

The Economos Group

949 854 6600 ■ www.economosgroup.com
4650 Von Karman Ave Newport Beach CA 92660

stocks down to what we estimate is a roughly 18% discount to our estimate of NAV, and in general, sizable discounts to the replacement cost of the assets."

In regards to brick and mortar investments, Principal Global reported that the current bearish sentiment in the public REIT market suggests a high probability of a broad-based increase in cap rates in the U.S. driving down NAV over the next few months. However, this indiscriminate sentiment could make for an investment play for specific properties or locations. While they don't expressly say so, Principal's rationale points towards a return to core properties investing.

"It seems likely that the impact on cap rates will be more situation-specific, discriminating and dispersed than what is currently being impounded into public REIT pricing assumptions," Principal reported. "Properties that are of lower quality, located in secondary and tertiary markets, subject to weak landlord pricing power, and that were heavily dependent upon the ultra accommodative lending markets (especially CMBS) to help drive down their overall cost of capital may likely see much more upward pressure on cap rates going forward than properties and markets with more favorable characteristics."

Involuntary Deleveraging Anyone?

Granted, Principal wrote, some of the shift in debt reduction (deleveraging as Principal calls it) would be voluntary as property owners become more risk averse and react to higher costs of debt capital. But, "most deleveraging will be involuntary, dictated by much less accommodative lending markets, whether on new financing or refinancing activities. Involuntary deleveraging also includes the likelihood of an uptick in default rates and foreclosures, partially due to increased balloon risk."

As properties are sold or refinanced, equity will be needed to backfill debt that is no longer available (or no longer nearly as favorably priced,) Principal wrote. The most vulnerable properties and markets are those where the incremental cost of substituting equity capital for debt capital is the highest. Those properties and markets that benefited the most from excessively low debt spread premiums in the past likely face the greatest potential upward pressure on cap rates in a much less accommodative lending environment in the future.

"For high quality assets in primary markets, especially those with sustained landlord pricing power, any uptick in cap rates may likely be much less dramatic, because there is a much greater likelihood of sufficient demand for these properties from all-cash and lower-leveraged equity capital to keep the incremental cost of equity capital low relative to the debt capital it will be replacing," Principal argued. "In addition, there is a greater opportunity for increases in net operating income to stay ahead of upward pressure on cap rates in these properties."

Having said that, there are some caveats, Principal wrote. Even high quality properties in primary markets could see a material increase in cap rates in situations where ingoing cap rates are very low due to contract rents being well below market rents.

Of course, Principal wrote, continued strength in real estate space markets is dependent upon the current turmoil in the credit markets not spilling over into the real economy and causing either a recession or prolonged slowdown in economic and employment growth. As they say, forewarned is forearmed.

(Editor's Note: Just what are those quality investments and markets? We'd like to hear from you and as we do, we'll update the story throughout the day. Are we seeing a return to core properties away from value-added opportunities? Tell us what you think. E-mail me at [Mark Heschmeyer](mailto:Mark.Heschmeyer). Read excerpts from pertinent follow up comments at the end of the story as they are added.)