

Special Report: Bankruptcy & Auctions

Equity capital new king of commercial real estate

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A group of investors led by Starwood Capital Group and private equity firm TPG, formerly Texas Pacific Group, beat out seven rivals to win Chicago-based Corus Bank's bankrupt \$5 billion condo portfolio with a combined bid of \$2.77 billion.

Starwood's up-front stake was only \$554 million, and hands the company and its investor partners 112 construction loans, more than two-thirds of which are in default or foreclosure. As a result, Starwood Capital quickly emerges as the condo king of South Florida and the once-hot and now-beaten markets like Las Vegas and California.

To sweeten the acquisition deal, the Federal Deposit Insurance Corp. provided up to \$1 billion over the next five years for any unfunded commitments, construction overruns and carrying costs for bank-owned inventory, at an effective 0 percent interest rate, and took a 60-percent equity stake in the Starwood partnership. Investors would have to pay off any of that debt plus \$1.38 billion in debt issued by the FDIC before they can begin collecting on their investment.

The bid was 20 percent higher than competing offers, and many speculate whether Starwood overpaid for the transaction. Is this an opportunity for equity capital to take advantage of the market or a case of too much equity chasing a potential yield? Time will be the arbiter. But the last time such opportunities existed — almost 20 years ago — such transactions proved to be significant windfalls. The Miami Tower built for CenTrust and purchased by Winthrop is one such example.

The Corus transaction illustrates the opportunities equity capital can uncover and discover in today's "frozen" debt markets as the illiquidity first experienced in 2008 transitioned into 2009. The big names in commercial real estate were not the pension funds, real-estate investment trusts or life insurance companies that invested in and originated billions of dollars in commercial real-estate transactions before 2008 and 2009. They were not the large investment banks and commercial banks such as Goldman Sachs, JPMorgan Chase, Bank of America or Wells Fargo, which originated billions of dollars in commercial loans and mortgage back securitizations.

The names being spoken by the real-estate professionals today are DebtX, First Financial Network, Carlton Exchange, Eastdil Secured, Garnet Capital Advisors and Mission Capital Advisor.

Redeploying Funds

These names, unfamiliar to anyone not directly involved with commercial real-estate debt markets, have come to prominence as auction houses and loan sale advisers help regional and community banks staunch portfolio losses and return desperately needed capital back to the institutions' balance sheets. In addition, they are the conduit that has allowed the FDIC to regain liquidity from the sale of loans acquired from failed banks and thrifts. This, in turn, permits the organization to redeploy funds to systematically and efficiently shutter insolvent financial institutions without insured depositor loss. The FDIC has been adding to its stable of note-sale advisers and recently — perhaps ominously — contracted with one for a five-year term.

While this isn't new — many of these names established themselves in the days of the savings-and-loan crisis with the Resolution Trust Corp.'s substituting for the FDIC — the sale of loan notes and real estate-owned assets through the use of sealed bids and auctions has provided a baseline for the valuation of commercial real estate. The difference now is equity capital has substituted for debt capital, forcing prices down to allow investors to realize the necessary yield to compensate for risk.

The expectation that the commercial real-estate market will enter a freefall akin to the housing market has not presented itself; neither has the expectation by lenders that the market will make a quick recovery.

The result is that the fundamentals of sound investing will prevail — location, location, location, with manageable leverage and proven and realistic expectations of cash flow. Commercial real estate trades on its ability to generate cash flow, and the returns investors require determines its value.

As the recession worsened and 150 Ponzi schemes representing every state were uncovered in 2009 alone, investors today are seeking realistic returns on capital that are tangible and have straightforward investment strategies. Commercial real estate deals that work on a realistic return on investment coupled with a determination of a return of investment will provide the benchmark for 2010.

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