

The Longbottom

By Matt Slepín, *Managing Partner*

The real estate business is starting to repair itself and we're hearing some good news in the economy. With the end of the freefall, many people are feeling optimistic. At ULI a few weeks ago I kept hearing, "Thank God, 2009 is over." This has people talking recovery, about maybe even a quick one, but we are predicting a long, slow slog we're calling the "Long Bottom." We expect lots of fits, starts, and surprises that will take several years to play out before there is a true recovery, at least in the commercial real estate business. How are we seeing this play out at this point for both companies and people in our industry?

Mixed messages abound. The stock market was chugging along very well until the mini-crash last week, which demonstrated either skittishness or a computer blip, both are concerning. Last month showed increases in consumer spending and good overall economic growth and we have mixed job numbers (a combination of positive job creation but an overall rise in unemployment). Greece and the Gulf oil spill are scary and you know there will be some other shoe in the not-distant future.

Until there are meaningful increases in employment, the drivers for the fundamentals in real estate will remain negative or, at best, stalled. Last quarter's data on the residential market shows that home prices and sales seem to have hit bottom and are in some sort recovery, albeit an anemic one. On the other hand, except for strangely low cap rates, commercial real estate overall is well behind single family in terms of bottoming out – probably several years to wash the problems through the system. And, in large part driven by problems in commercial real estate, banks are continuing to fail and we hear that more is to come. Finally, we have to get past the CMBS maturities issue, which has three or four years to run its course, before the overleveraged deal overhang is washed through the system.

Our clients are dealing with the Long Bottom in many ways and the good news is that this new feeling of stability allows companies to plan and build their organizations for the next cycle. Most of the moves we've seen are strategic ones, versus simple re-hiring. We will feel more confident in the recovery when companies start re-hiring and expanding their workforce.

A good example is a client for which we recently completed a VP of Property Management search. This company had recently streamlined their organization from three regions to two and needed to hire externally for one of the two positions in order to bring in the right skill set. While we were doing the search, the client created a new role, bringing in a new senior level marketing person and cutting what felt like an unnecessary layer at the top. Net-net, their organization maintained the same headcount, but they now have both additional skill sets and a stronger team. Smart moves.

We've seen similar moves in the retail sector where we've helped several clients bring in stronger internal leasing talent. The name of the game in retail is leasing and owners have used the opportunity of the pain in the marketplace to build and upgrade their internal leasing teams. It's a critical move.

On the other hand, I visited with another company recently that had virtually no cutbacks during the recession. Sounds ideal on the surface, but a frustrating missed opportunity for the senior executive with whom I'd visited. It's harsh, but executives need to use this time to plant and prune; Rahm Emanuel was correct with his comment "a recession is a terrible thing to waste."

On the finance side of the business, we see evidence of baby steps back into the market. I had breakfast recently with the CEO of Bay Area based Redwood Trust (www.redwoodtrust.com), which was the dominant player in non-agency, jumbo residential mortgage securitizations over the past 15 years. Redwood Trust just put their toe in the market with the first post-crash, non-agency residential mortgage securitization. It was a relatively small deal asset-wise, but a huge step forward for a highly dysfunctional market.

On the multifamily side, Freddie Mac just announced the appointment of four firms to provide mezzanine financing on their transactions. All four are traditional equity players who could underwrite the mezz deals, but be ready to jump in as owner/operators if the transaction goes south. Similarly, the traditional Wall Street CMBS players are back in the market and deploying teams, albeit at skeleton levels as compared to the heyday. More evidence of slow but sure repairs.

The transaction side of the business is even more interesting. We recently completed a search for a multifamily merchant builder creating an acquisition platform. The hiring process was an outlier in my search career in terms of supply/demand imbalance in favor of the employer. Finding great talent in this functional area (and others as well) is indeed "the buying opportunity of a lifetime."

When in Denver recently, I visited with leaders from both Archstone and UDR. Apart from having been the top-of-the-market poster child, Archstone has maintained its senior team and its operating platform has performed among the best in the business. That company will certainly reemerge with new stable-state capitalization, but unlikely in the immediate future. UDR is well positioned among its peers, but seems also to be in no rush to action in this still evolving marketplace.

While in Boston for ULI, I had the opportunity to visit with two companies that provide bookend stories in the Low Income Housing Tax Credit niche of the business. One is Boston Financial (www.bfim.com), an organization that is under new leadership and ownership, and has reclaimed its old name. The company has a \$10 billion portfolio and is looking for new opportunities. The other is Tax Credit Asset Management (www.taxcreditam.com), which fields a team of deeply experienced professionals in the business. In less than a year of business, TCAM is asset managing almost 300 properties for a dozen institutional clients. What's interesting? Like other sectors in the real estate business, the tax credit business is going through a painful restructuring and reinvention process. Both Boston Financial and TCAM are deeply involved in that sector, standing around the hoop, and positioned to prosper as the future of that business unfolds.

Similarly, start ups are getting their ducks in line and established companies continue to prepare their organizations and capital structure for the recovery. We have long believed that down cycles like this will wash out some firms and see the creation of new names. I have watched my wife as she and her partners have put together a new investment firm, W3 Partners (www.w3partnersllc.com); all indications are that W3 will be one of the new names on the block. However, one needs patience through what can be a lengthy start up phase. Many the myriad start-ups will not make it and will wind up having been savvy under-the-hoop place savers for their teams.

Indeed, patience in the Long Bottom might be the biggest challenge. We all know how much capital is on the sidelines ready to be deployed. The challenge, however, is painfully limited deal flow, which has driven the combination of crazy low cap rates with low price-per-pound basis. Transaction volume will return to some level of normal at some point in the future, the can just can't be kicked down the road forever. However, in the meantime, will capital have the patience to be disciplined and will companies be able to pay their overhead without the fees generated from new transactions?

And will the significant number of still unemployed and underemployed real estate professionals also have the patience to make it through to the recovery? A lot of it depends upon economic wherewithal, but it also has to do with time-of-life, area of expertise, geography, and other factors. Indeed, although the world is speaking recovery, the number of resumes we are receiving is unabated, particularly for transaction and development professionals. Staying-around-the-hoop, networking, consulting, and starting new businesses continue to be essential strategies since we still predict that reemployment in the Long Bottom will take some time. (See our prior articles, "Weathering the Storm" and "Surviving the Great Recession" on our website at www.terraresearchpartners.com for tips)

I feel like a naysayer to all of the talk about recovery, but this feels like the truth. The good news is that our expression, "Long Bottom," is just another way to say "Slow Recovery." Inevitably, companies, people, property values, and new financing tools will find a new sustainable level as the market loosens and transaction volume returns to a norm. We certainly hope for a snap back, V-shaped recovery, but let's be prepared for the Long Bottom.