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Bid vs. Ask

Motivated investors are closing the pricing gap on institutional assets.

by Michael P. Hedden

Activity within the institutional commercial real estate market is picking up as a result of the abundance of capital seeking real estate opportunities. Property sellers who have been holding firm in their asking prices are being rewarded for their patience by buyers who are motivated to procure quality assets at perceived attractive prices. Rather than simply bid the price to unrealistic levels, buyers are analyzing numerous alternatives to achieve ownership positions and obtain attractive returns on their investments.

The Buyer Perspective

From the buyer's perspective, each acquisition is a case study in strategic methodology, analyzing and pursuing numerous avenues to the transaction. Recently, a trend has emerged in the form of joint venture partnerships where buyers assist in the recapitalization of the assets that are facing loan maturity deadlines on debt with high loan-to-value ratios. Alternatively, purchasers of a property's debt can foreclose upon its default and obtain title to the property through a loan-to-own strategy.

Another approach is to wait for the lender to foreclose or a bankruptcy procedure to play out when an owner defaults and then purchase the property in court. Of course,

for core assets that are highly desirable and attract considerable buyer competition, direct acquisition of the asset from the seller is the most reliable and traditional method.

As evidenced by recent deals, motivated investors have used all of these means to procure core real estate investments in prime markets and this trend is expected to continue through year-end. But as the supply of attractive purchase opportunities shrinks, buyers are starting to take on riskier assets in less-than-prime markets.

Tolerating Risk

With this increase in transaction activity comes the price discovery and transparency of an evolving market. The convergence in

the bid-ask conundrum is now coming more from the buy side than from the sell side — more from the bid than the ask. The abundance of available capital, both debt and equity, has been the primary reason for this increased buyer activity.

With the pressure and incentive to put real estate equity capital to work, the risk tolerance and go-forward assumptions regarding cash flow expectations have become more optimistic and are driven more by the need to invest than by market fundamentals. The willingness to take on more risk in real estate transactions combined with increased competition has shortened the due diligence periods for aggressive purchasers of prime super-core assets.

Over the past several years, many investors have raised significant pools of funds with the expectation that distressed sellers facing foreclosures, bankruptcy, or refinancing would be willing to sell prime assets at distressed prices. That has not been the case. In some cases, the institutional buyers have been motivated to invest and have paid premiums rather than allow the raised capital to sit idle causing them not to meet the fund investors' expectations.

The sellers of real estate or mortgage note holders have seen this increase in volume and

upward price movement for certain assets and are content to hold out or kick the can down the road. The strategy of delay and forbearance has enabled sellers to become firmer in their pricing as the market slowly recovers. Since the credit crisis began more than three years ago, sellers were anticipated to follow the same pattern that unfolded during the late 1980s market collapse, with liquidation at distressed prices. However, in many cases, asset owners and debt holders have opted to hold out for a market recovery.

Buyers are starting to take on riskier assets in less-than-prime markets.

As a result, a convergence of market pricing is occurring, with more buyers raising their bids than sellers lowering their asking prices.

The fact that the ample supply of capital chasing too few available core assets has driven the recent price increases is reflective of the basic economic principle of supply and demand.

Buyers have developed a more-strategic approach to making acquisitions that is reliant on a case study approach to each situation. The current environment gives buyers several options to acquire a desired asset. The analytical tools market participants use are the same, but the process differs depending on the competition, market fundamentals, and capital availability. Debt and equity availability in the right proportion cannot be taken for granted. Due diligence and deal structure are more important than ever

and the expectations of the future are more circumspect.

In those markets that have become heated, such as New York and Washington, D.C., less time is spent on due diligence. Instead, more-aggressive valuation assumptions are being underwritten in order to beat out the competition, putting upward pressure on

bid pricing and limiting the need for sellers to concede on asking prices. In those markets where time is not of the essence, a more-strategic case study approach to the acquisition can be made.

Transactions today reflect the combination of the deal-specific complexities faced by prospective sellers with the bid-ask convergence. The result is the resurgence of risk taking by prospective buyers with the increased availability of debt and equity. The real estate market is showing signs of recovery and, as a result, the pace of transaction activity continues to accelerate; however, the new framework under which real estate transactions are being executed is carefully thought out and very strategic.

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