

S P E C I A L R E P O R T

Can You Handle the Truth  
About Emerging Trends  
in Real Estate 2011?

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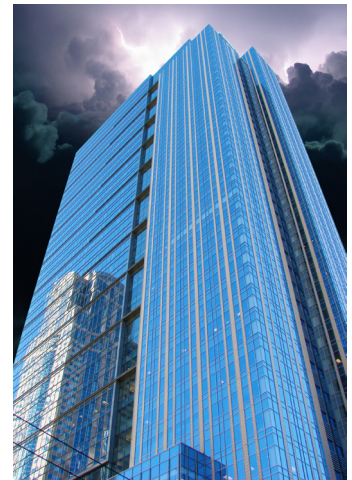
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## Can You Handle the Truth About Emerging Trends in Real Estate 2011?

*An analysis by Lane Powell PC and CB Richard Ellis' Private Client Group*

It's that time of year again. The Urban Land Institute and PricewaterhouseCoopers released their 2011 annual forecast, "Emerging Trends in Real Estate." According to the forecast, Seattle ranks sixth overall in market quality for real estate investments, and reports the commercial real estate market to be showing small but positive signs of improvement. However, not all the news is good. In an effort to digest the extensive forecast and analyze what the forecast means for the Pacific Northwest from a market and legal perspective, a team from CB Richard Ellis' Private Client Group (CBRE PCG) and attorneys from Lane Powell met to discuss the forecast. The following excerpts were taken from their conversation.



*Non-recourse loans have seemingly disappeared—at least for debt under \$10 million. Assuming this trend continues, how will it affect property values below \$20 million?*

**CBRE PCG:** The seeming disappearance of non-recourse debt, we believe, is a temporary aberration, which stems from too few lenders in the market. There are ample signs that more lenders are coming back to the market—after all, making loans is supposedly what they do. A major 'driver' in the return of non-recourse debt will be the re-emergence of commercial mortgage-backed securities (CMBS) loans as those are nearly all non-recourse. Some CMBS debt is now available, largely for core-type properties. However, as securitizations become more common, both loan size and property types will change bringing more debt opportunities to the market. Other lender types such as banks, life companies and others will, to a degree, have to follow suit to compete.

**LANE POWELL:** Rents and property values need to stabilize before lenders will look seriously at non-recourse lending. Because the borrower has no direct obligation to repay the debt in a non-recourse loan, non-recourse loans are only made when the lender is confident that the real property collateral will be sufficient to repay the debt if the borrower defaults. Although lenders can foreclose on the property in a default situation, they won't be able to get a judgment against the borrower. As a result, the rental stream and potential resale value of the property become all-important. Until rents and property values become sufficiently predictable, lenders will have difficulty underwriting non-recourse loans.

*Off-shore investors have been credited with driving pricing on investment real estate while adding to the supply of available debt capital. To the degree this has been true in the past, will this investment continue in the future and to what effect?*

**CBRE PCG:** The United States continues to be the 'safe haven' for conservative foreign investment. In addition, as merging countries prosper and accumulate capital, the overall volume of 'money seeking a yield' will escalate. High quality 'trophy-type' properties have traditionally been the asset of choice with foreign investors who treasure probable yield more than 'upside.' The foreign appetite for high quality real estate will continue to put pressure on pricing until, and unless, other investment arenas begin to draw capital away from the United States. Seattle, being a 24/7 global gateway city, will continue to attract foreign capital, but not in the same quantity as New York, San Francisco and areas of Southern California.

**LANE POWELL:** Since the mid-1980s, U.S. issuers have sold bonds and other debt to foreign persons who have been able to take advantage of the portfolio interest exemption, which exempts interest paid to certain foreign persons from U.S. tax. As a result of recent legislation, interest paid on certain debts to foreign persons will now be subject to a 30 percent withholding tax, unless a tax treaty applies that allows otherwise. In addition, even if the debt obligation is of a type that would qualify for the portfolio interest exemption, the exemption from tax will only apply if the foreign person discloses certain personal information on IRS Form W-8. As a result of this new legislation, U.S. issuers of debt will have to revise programs to prohibit the selling of unregistered debt to foreign persons and will need to convince their foreign investors to provide the personal information and certification required by IRS Form W-8. This, in conjunction with the current low interest rates, could have a significant impact on available debt capital.

*The participants interviewed for the Emerging Trends forecast generally believe that 2011 will see more bank-owned properties come to market. Do you expect to see this trend in the Seattle area and, if so, why? What common traits will these properties have, if any?*

**CBRE PCG:** The Seattle area differs in several ways from many other areas of the country: 1) lower unemployment<sup>1</sup>; 2) lower vacancy rates<sup>2</sup>; and 3) fewer foreclosed properties<sup>3</sup>. Many distressed properties have been effectively taken over by FDIC sponsored ‘suitor banks,’ thus relieving much of the immediate stress to liquidate. Some bank-owned properties in the Seattle area have come to market with mixed results. A property is described as distressed for a reason (it has problems with leasing) likely stemming from issues with design and location, and financing these problems is currently exceptionally difficult. A key question for the future is whether banks will embrace a policy of providing financing for these properties they wish to sell. So far the answer is usually no, but if the desire to liquidate overrides the desire to ‘just be done with this thing’ these properties will likely sell both quicker and for higher values. We do expect to see an increase in distressed property offerings going forward as lenders improve their reserves and market pricing becomes more predictable, but we caution investors to temper their anticipation as prices may not engender drooling and again, there is a reason they call these properties ‘distressed.’ For those interested, there are a multitude of lists available that market bank-owned properties such as CBRE’s Auction Services or Loopnet.

**LANE POWELL:** As a regulated industry, banks are typically allowed to own these types of properties for five years. For many properties, the five-year limit is approaching. Although banks can request extensions on the holding periods, it seems inevitable that banks will market an increased number of their properties in 2011, due to the sheer volume of properties acquired by banks in the last few years, and the need to sell the properties before the five-year deadline.

<sup>1</sup>*Puget Sound Economic Forecaster* reports an average of 8.83 percent across the local metro area, compared to the U.S. average unemployment rate of 9.5 percent at the close of third quarter 2010.

<sup>2</sup>CBRE Econometric Advisors notes declining availability across all major commercial property types: office, industrial, retail and multi-housing, throughout the first three quarters of 2010.

<sup>3</sup>The Seattle area registered only 166 REO commercial properties with an approximate total of \$3.2 billion in estimated value at the end of October 2010, according to Real Capital Analytics. Meanwhile, the national REO inventory mounted to nearly 11,000 distressed properties with a total estimated value of 191.8 billion.

*The market has been ripe with rumors over the past 18 months about a potential tsunami of foreclosures from defaulting CMBS loans, but so far this has not materialized. What is the current industry expectation with respect to these loans?*

**CBRE PCG:** The CMBS loan structure is the issue. The majority of money (usually about 60 percent) in every loan in the CMBS pool was contributed by the ‘A’ bond holders. However, the real power in a CMBS loan workout lies almost exclusively with the subordinate, or ‘B’ bond holders, due to their veto power. The B holders, resisting the idea of being wiped-out, are inclined to work with the debtor and/or the property in the attempt to increase the probabilities of recapturing some of their investment, while avoiding foreclosure. Unless the property and/or the local market have material or insurmountable issues, usually time and some additional capital will solve much of value equation—so why sell early? We do expect to see new offerings in 2011 from the special servicers handling these properties as bond holders agree to shed smaller troubled assets in order to focus on larger loans and properties. There will be opportunities with these properties, but expectations should be tempered.

**LANE POWELL:** Even if the B holders reach agreement, CMBS foreclosures may encounter the same kind of paperwork issues currently associated with residential mortgage-backed securities (RMBS) foreclosures. In both CMBS loans and RMBS loans, there is a bulk transfer of the loans into the pools, and there is not necessarily a separate assignment for each loan to the pool. When a foreclosure is commenced, the trustee (or the court in a judicial foreclosure) will require the foreclosing lender to produce an original promissory note and deed of trust for each loan in foreclosure, including any assignments of those instruments. As we have seen with RMBS foreclosures, the lenders may have insufficient documentation to prove that they are the holder of the promissory note and the beneficiary under the deed of trust. If this is the case with CMBS lenders, it could cause the same delays that we are currently seeing in the residential arena.

Participants in the discussion included Steve Sutherland and Craig Wilson at CBRE, and Jane Nelson, Paige Davis and Timothy Jones at Lane Powell. This special report is intended to be a source of general information, not an opinion or legal advice on any specific situation, and does not create an attorney-client relationship with our readers. If you would like more information regarding a legal or tax planning issue, please contact one of the Lane Powell lawyers, using care not to provide any confidential information until Lane Powell has notified you in writing that there are no conflicts of interest and that Lane Powell has agreed to represent you on the specific matter that is the subject of your inquiry.

To learn more about CBRE's Seattle Private Client Group and distressed commercial property opportunities in the Puget Sound area, please click here: [www.cbre.com/pcgseattle](http://www.cbre.com/pcgseattle)

To learn more about Lane Powell, please click here: [www.lanepowell.com](http://www.lanepowell.com)



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