

# A Return to Fundamentals in Times of Crisis

Since the financial markets began to wobble in mid-2007, the commercial real estate industry has been holding its collective breath as it awaits the full impact of the financial crisis. Those in the real estate industry have cited limited new supply and once-strong market fundamentals as cause for optimism, but unmistakable change has come to the industry.

ONE OF THE MOST NOTABLE changes in the real estate industry as of late has been the return to a fundamental practice of underwriting equity investment in commercial real estate. Gone are the days when buyers underwrote to operational perfection, only to have been replaced by a more prudent and thoughtful assignment of risk to all aspects of the physical and financial analysis. The framework and timing during which a transaction is executed have fundamentally changed as well. Normalized due diligence periods and more buyer-friendly contracts are a couple examples of this.

The commercial real estate market's peak can generally be characterized as a period during which buyers were forced to stretch underwriting standards in an effort to make deals. Market rent, rental growth, lease-up timing, and exit capitalization rates are but a few of the critical valuation levers that were continually being tweaked to allow a deal to make financial sense. A spirit of optimism fueled largely by freely available debt caused a number of participants to believe that a shift had occurred in the pricing of real estate. However, the onset of the financial crisis, and ultimately the lack of available debt, ushered in a new approach to underwriting commercial real estate.

## Underwriting Property Income

The income section of the pro forma statement has been substantially transformed as a result of the financial crisis as buyers exhibit a far greater concern for in-place income over future projections. Starting market rent, rental growth rates, other income, lease-up timing of existing vacancies, and the like have become hot discussion topics around investment committees as

buyers are choosing to dial back these assumptions to be at or below recent operations.

Buyers are said to be taking a much more conservative approach to setting market rental rates and using leasing comparables cautiously. Buyers are discounting the most recent comparables when setting market rent, effectively resulting in negative initial rent growth. They are also assuming that the first and second year of rent growth are generally 0 to 1 percent, with most buyers using inflationary growth in the remaining years. Rental spikes are still fairly uncommon as is negative rent growth beyond the initial setting of market rent.

Rental concessions and other tenant inducements are coming back into a variety of markets around the country. Brokers indicate that most buyers are underwriting face rates that are near or slightly discounted to market comparables, but are assuming more free rent and higher tenant improvement packages. The presence of concessions is highly market dependent, however, with infill markets naturally seeing lower concessions than suburban markets.

The underwriting of existing tenancy has become particularly delicate over the last 18 to 24 months as there is a distinct lack of certainty concerning the credit quality of these tenants. Buyers are assuming that most in-place tenants will pay rent through the lease term and are not underwriting bankruptcies or premature tenant vacancies with the exception of those clearly under current duress. Buyers are, however, assuming tenants vacate upon lease termination if they are the least bit financially unstable as opposed to assuming that a percentage will remain.

Other income, which is generally revenue associated with leases

on space such as parking garages, exterior signage, rooftop antennas, and the like, has also become highly scrutinized by prospective buyers. Buyers, for example, used to underwrite other income that had not yet been generated by the seller but that the buyer had a reasonable chance of being able to capture. Since the financial crisis, however, buyers have not been underwriting other income that is not readily observable in recent operating statements. Buyers are clearly concerned about the historical ability to attain this added income and generally assume no future growth of the other income line-item if it is underwritten.

A decided shift has also occurred in the buyer underwriting of vacancy. In-place vacancy was viewed as a positive by buyers during the run-up and peak of the market cycle, as this was seen as an opportunity to lease space at the higher underwritten rates. The tide has turned, however, as buyers are no longer paying full price for the vacancy. Buyers will pay for some of the in-place vacancy, but they will want it at a discount. Buyers are "hitting us hard on vacancy," say brokers, noting that what used to be a six-month downtime has increased to 12 months.

## Underwriting Property Expenses

Although the income side of the pro forma statement has experienced the greatest change following the financial crisis, the expenses also have been affected to some degree. The most substantial adjustments relate to the underwriting of capital expenditures and tenant improvements, but operating expenses also are being scrutinized to a lesser degree given the triple net lease structures of many office and industrial buildings.

The fundamental change relating to capital expenditures is that sell-

ers are being much more realistic about the necessity of underwriting capital and buyers are getting more aggressive with including capital and requesting price reductions when non-underwritten capital is discovered during due diligence. Most brokers indicate that sellers are being much more realistic about near-term capital as well as out-year capital, which had historically been covered in large portion by the buyers. Sellers are being far more upfront with buyers regarding the necessary capital because hiding it no longer works. For example, in the case of a conversation between a buyer and seller over a very small dollar amount associated with a capital deficiency, nowadays the seller might willingly adjust the price—whereas the buyer would not have even broached the subject of this expense with the seller in the past as the buyers would have just incurred the expense themselves in the underwriting. Buyers also are increasing their underwritten capital reserve amounts for older buildings to adequately reserve for undiscovered capital deficiencies.

Tenant improvements have also begun to increase as buyers anticipate a more challenging leasing environment. In some cases, tenant improvements have increased 15 to 20 percent over the last 18 to 24 months. In other cases, tenant improvements have increased, but not as much as free rent since tenants are placing a higher value on free rent given that they are no longer building out elaborate space. As would be expected, tenant improvement packages are observed to be more extensive in suburban locations than in infill markets.

Buildings with non-triple net lease structures are also seeing scrutiny on operating expenses, but not to any greater degree than prior to the financial crisis. Similar to the income side, buyers are clearly concerned with the pro forma expense levels and the manner to which

they relate to historical operating expenses. Property taxes and insurance continue to receive a great deal of attention from buyers as they try to anticipate the implications of the next assessment or insurance repricing.

### **Due Diligence and Contract Negotiation**

The financial crisis has resulted in a fundamental shift in the manner in which buyers and sellers are underwriting equity investment in commercial real estate, but there have also been distinct changes to the due diligence and contract negotiation processes. These processes are critical to properly underwrite commercial real estate as they provide support for the underwritten assumptions. The following is a summary of the most significant changes that have occurred since the onset of the financial crisis.

**Due Diligence.** Buyers' renewed sensitivity to risk is resulting in a greater degree of caution being exercised during due diligence when underwriting assumptions are validated. While due diligence has always been a standard part of the transaction process, buyers are requesting and receiving more normalized inspection periods relative to the highly compressed periods seen during the market run-up.

Prior to the credit crunch, for example, inspection periods could be as short as ten days or less in duration, whereas now buyers are negotiating a minimum of four weeks. This time is primarily being used to thoroughly inspect the property and fully understand the market and tenancy. A significant amount of the due diligence period is also being used to obtain financing if available.

Prior to the financial crisis, sellers were demanding shortened due diligence periods, putting extensive time pressure on property inspections and causing some potential buyers to conduct time-intensive

procedures such as engineering and environmental testing before the property was ever under contract. Sellers were able to demand that multiple buyer groups front-load due diligence to eliminate the risk that buyers would request a price reduction once the deal was formally awarded. These significantly compressed due diligence periods caused concern throughout the industry that critical factors would be overlooked, causing some buyer groups to drop out of the bid process as a result. The financial crisis and subsequent reassessment of risk have normalized the inspection periods as a smaller buyer pool has been able to negotiate more buyer-friendly due diligence periods.

In addition to inspections, buyers are needing the increased due diligence time to coordinate debt financing for the transaction. While sellers prefer all-cash buyers, there is a realization that the only potential buyers for lesser-quality properties might rely on debt as part of their underwriting. The credit markets have made the process of obtaining debt increasingly difficult and would-be borrowers are often approaching numerous lenders to find their required loan, if one is even to be found at all. Sellers recognize these market conditions and are tailoring time periods that allow for the necessary arrangements since a leveraged buyer is sometimes the only alternative.

**Contract Negotiation.** The financial crisis has also changed the negotiation of legal documents and closing contingencies related to transactions. A renewed concern about risk has been seen in the representations and warranties associated with the property. These clauses give the buyer guarantees on issues including the legality of tenant leases and service agreements as well as any unforeseen property conditions. Real estate attorneys suggest that since the financial crisis, buyers in

some instances are even requiring representations on the projected occupancy of the property at the time of closing because of its critical effect on property performance. Future risk exposure is also being hedged by extending the survival periods that dictate how long the seller is responsible for legal ramifications of representation and warranty violations.

The closing date, once an unchangeable deadline set by the seller, now comprises a degree of flexibility based on contingencies within the contract. These contingencies are negotiated by the buyers to allow them to meet pre-defined conditions before funding and usually contain elements such as satisfactory environmental report and tenant estoppels. Because of the instability that now exists in both equity and debt markets, recent contingencies also include the buyers receiving internal approval from their investment committee and securing adequate debt financing.

The larger financial system has experienced a significant amount of distress and change that has yet to be fully experienced in commercial real estate. Indications suggest that this sector will by no means be immune from the full impact. There currently are dramatic changes in the manner in which office and industrial real estate is being underwritten today, but the persistent bid/ask spread between buyers and sellers has yet to dissipate. This spread has precluded the full impact of underwriting and adjusted return requirements to represent themselves in the form of transactions. Only time will tell what is fully in store for the industry. **UL**

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