Legacy Real Estate Advisors

Real Estate Investor Insights

Newsletter Highlights

- Re-opening businesses and the effect on the CRE Industry
- Tenant Trends
- Capital Markets and Mezz. Debt
- Evaluating Risk
- Is it time to buy or sell?

Investment Real Estate During Economic Downturns Mitigating Risk and Capitalizing on Opportunities*

For most real estate investors the last decade has produced consistently significant returns across all market sectors. During the past three years alone, The Boston MSA has experienced historically low vacancy rates, historically high rental rates and unprecedented growth. The low interest rate environment, aggressive corporate growth and a robust stock market had essentially eliminated much of the risk normally associated with real estate by delivering high yields on what had been essentially passive income.

While the Capital Markets should remain stable, albeit more restrictive loan covenants, clearly the tenant landscape has changed. Companies in every sector are re-examining their space needs, with some sectors including Retail and the Collaborative Workspace Industry being more affected than others. Further complicating the situation is the unknown of what type of protocols will be imposed on the reopening of many businesses and multi-tenant office buildings. While many companies have managed in the short term, their challenge is determining what their future needs will be.

The inevitable by-product of companies downsizing, closing, and needing less space in the future will be an increase in vacancy rates, including an increase in sublease opportunities. The correlated result will be an overall decrease in rental rates. *The biggest question is when statistically do the markets stabilize, and what is the newly adjusted mean?*

Not only do increased vacancy rates affect rental rates, but it causes an additional challenge for investors in that it becomes much more difficult to predict how long it will take to lease vacant space; what the rent will be, and what inducements need to be offered to attract tenants.

* statistical information provided by

THOMPSON HENNESSEY & PARTNERS
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ANTICIPATED DYNAMICS FOR CRE

Rental rates across all asset classes will decline as vacancy rates increase and more options for tenants become available**.**

Transactional costs will increase. As tenants have more options, landlords will need to offer additional inducements such as increased tenant improvement allowances and higher commissions**.**

The credit rating of many companies may decline affecting the value of investment real estate including the ability to finance it.

While debt may remain inexpensive, lenders may be more restrictive in underwriting including lower LTV's and more restrictive loan covenants such as personal guarantees, and increased cash reserves.

Landlords should anticipate vacant space remaining available for much longer periods.

Tenants may require much more flexibility in their leases including shorter terms, options to terminate, and broader sublease provisions

The need for mezzanine financing. For many, conventional debt may not be available for the next 6-9 months and interim capital will be needed to close transactions. Due to increased demand, we have seen both an increase in the number of private mezzanine lenders, including many Family Offices, and an escalation of terms. 9 months ago terms for a 6 month mezzanine facility would have included an 8-10% interest rate, 1-3 basis points as an origination fee, and an exit fee upon loan maturity. *For a similar deal today, the lender would require 3-5 basis points for an origination fee, 12-15% interest rate, an exit fee upon maturity and potentially a success fee 12-18 months after maturity based on the financial performance of the investment*

During economic downturns, real estate that previously has been providing passive cash flow can become an expensive and very risky investment in short order.

A Changing Perspective

While some of our clients are large institutional real estate investors, the majority are local business owners, High Net Worth Individuals, Family Offices, and Estates for whom investment real estate represents a portion of their overall financial plan. The greatest challenge we see for many of our clients going forward is that their real estate will transform from a passive cash flowing low-risk investments, to investments with declining returns, vacancy and credit loss, and more importantly the need for capital investment.

While managing investment real estate risk is something that many investors are comfortable with, for those who have inherited real estate, acquired it through divorce or death, or for those who have only recently begun to invest in real estate and may not have the experience to actively manage real estate, transitioning from passive owner to active investor may be problematic.

CONSIDERATIONS AND STRATEGIES

Evaluate your tolerance for risk.
As with any investment, consult with your financial advisory team to determine your tolerance for risk in continuing to own your real estate going forward. In some instances it now may make sense to sell if your investments will require new capital.

Equally important is to consider that if your investment real estate is planned for your heirs, estate or will be gifted, *you need to also consider the tolerance for risk and real estate expertise that the recipients have.*

Include a professional real estate advisor as part of your wealth advisory team to evaluate your real estate in the context of your overall financial plan, and implement a strategy to achieve stabilized cash flow going forward which may include selling certain assets.

Don't remain emotionally attached to your real estate. Real estate is simply an investment vehicle. Make objective decisions based on your financial goals and also take into account the appetite and acumen for real estate risk that your heirs or future gift recipients may or may not have.

Maximizing Value in a Sale: While investors typically focus on in-place cash flow, many also focus on upside potential so don't assume that if your real estate has diminished income its value has decreased proportionately. Well located, fundamentally sound real estate will still continue to be a sought after asset class. If you have a low basis in your assets and/or have minimal debt, *Seller Financing or a Joint Venture can be great ways to maintain value, maintain more passive cash flow, and minimize your risk.*

The 1031 "Trap" If you sell real estate with a low basis, while a 1031 Exchange is an effective way to defer your gain, you need to carefully evaluate the financial risk of the new investment. In many cases, paying your tax and re-investing your gain in more conservative investments can be more prudent.

Monetizing owned real estate: If you own both a business and the real estate, there are a number of ways to raise capital including a Sale-Leaseback whereby you sell you property and execute a long-term lease with the buyer. These transactions typically command a premium depending on the credit value of the lease.

Is it time to invest and where are the opportunities? If you have the financial wherewithal and experience to manage real estate in a downturn, there will definitely opportunities. Those include:

- *Families, estates and individuals that have either inherited real estate or accumulated real estate including through death or divorce whereby those properties may be problematic in that they require capital, management, and risk.* If these individuals do not want to sell on a fee simply basis, suggesting seller financing and/or joint venture may also be an option.
- *Closed-end private funds/REITS that need to sell by a date specific*
- *Individuals who have accumulated real estate and want to now monetize for retirement.*
- *Providing private bridge or mezzanine financing for real estate investments. In many instances that can yield returns in the low 20's in a 4-6 month period.*
- *Sale/leaseback transactions with business owners needing capital.*

Given that many of these opportunities will be off-market, it may be helpful to also work with the seller's financial planner to help them understand how the sale proceeds can be reinvested tax efficiently for retirement.

On a final note given that the capital markets remain fundamentally sound we do not expect to see deeply discounted opportunities and distressed debt that was prevalent in the '09 real estate recession.

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For over 30 years Legacy and THP have been providing specialized real estate advocacy services for business owners HNW individuals, and wealth advisors throughout New England. Our singular focus is to help our clients improve financial performance and increase profitability through the strategic use of real estate. Let our experience, unbiased and counsel, and diverse expertise enable you to create generational wealth through real estate.

Legacy Real Estate Advisors

Creating Generational Wealth

A holistic approach to real estate investing