



SPEAKER'S CORNER

by Ted Leary

It's "Over"

Experienced Workout Executives May Be Hard to Find

As each day passes, it looks like one of the great bull runs of commercial real estate is "over". We were already sliding into a global commercial real estate slump, and that slide will likely accelerate as the turmoil in the financial markets continues (this was written just after the wild Lehmann Bros.–Merrill Lynch–AIG weekend — and what a week this is turning out to be!).

In early September, *Business Week* had a story titled "Global Office Space is in the Basement". Similar stories are popping up almost daily around the world. It is quite hard to believe that the job losses tied to the implosion of the financial markets and the rapid contraction of capital will not have a severe impact on certain markets and property types.

Some places and some property types will obviously suffer more or less than others, but the office and retail markets in the United States, United Kingdom and Spain are clearly already experiencing diminishing values. As with many of these markets, it is difficult to tell precisely how severe the problem is or is going to be, as there are still so few transactions taking place.

I recently received a fascinating private e-mail analysis from an old friend who was a dominant, highly respected player in the workout days of the 1980s and early 1990s and who has lived in China for the past six years. His e-mail made a pretty compelling case that the Chinese real estate markets are a bubble in the making and are bound to burst. If he is correct, we can add that huge, currently popular market to the future workout list.

RISING HURDLES

I don't believe that we are heading for a disaster like we saw in the 1980s, with see-through office buildings and spec churches sitting out there on the Texas prairie. Other than the single family and residential condominium markets, the emerging problem is driven not so much

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by excess development but more by the "overs" — over-optimistic projections, which led to overpaying and then overleveraging.

On the positive side, the rapid contraction of real estate capital will mean that there is a low likelihood of overbuilding. With the tightening debt markets requiring more equity and increasingly more restrictive covenants, a growing number of owners are finding it difficult, if not impossible, to refinance their

debt and are facing a serious valuation and equity squeeze. A friend told me that there are commercial loans valued at more than \$100 billion (€70.8 billion) awaiting resetting over the next two to three years.

If accurate, that presents enormous hurdles — hurdles that moved up higher last weekend. It doesn't take a significant drop in revenues and increase in cap rates and debt costs to wipe out the equity of an aggressive buyer. If an asset is owned in either a separate account or a commingled fund, such an aggressive investment manager may have a difficult time going back to his investor(s) for more equity.

POTS OF GOLD?

Write-downs of the type I suspect are coming will present some interesting challenges to both the investor and adviser community.

First, some investment managers and advisers may be slow to admit to the problem, as most of them have follow-on funds in the works. It's tough selling a new fund if your existing funds are underperforming. That violates everything you learned in Marketing 101. Clients are becoming increasingly concerned and even distrustful as the real numbers start to dribble in. They will be unhappy over the fact that their investment managers might not have been forthright with them about problems in their portfolios and unhappy over the new numbers they have to report to their boards or investment committees.

The buzz on the street is that some U.S. public pension funds have already begun to investigate the falling values in their portfolios and are looking at the fees that investment

managers collected on previous funds that they do not have to pay back to offset current losses. It will not be good for the industry if firms are found to be “playing with the numbers” in a hope that a recovery will bail them out.

Second, poor performance can have a drastic impact on an organisation. Most investment managers have built up their staffs with bright young men and women who believe that they will participate in a “pot of gold at the end of the seven-year fund rainbow”. This is especially true now, as we have a cadre of young executives who have never experienced challenging, if not downright difficult, markets.

If they discover that, because of poor fund performance, there will likely be no “pot of gold”, there is a very high likelihood that they will seek other opportunities. This can seriously destabilise an organisation and make resolving a fund’s difficulties ever more difficult. I know from personal experience how just one poorly performing asset can drag down the returns of an entire fund and thus significantly reduce — or even eliminate — a much anticipated incentive fee.

This will, I believe, be an even greater problem now, as the recent “price it to perfection” market was so overheated that it essentially left no room for error. Well, errors have occurred, some of them quite serious. Given the growing extent of the problems in the economy and thus in the real estate sector, virtually any real estate investor or investment manager is going to suffer some problems. When the tide recedes, it takes even the best boats with it.

IT PAYS TO BE FRANK

The issue is how investment managers decide to deal with it. My advice would be to be as open and frank as possible with your investors. The investment managers who are open will retain the confidence of their clients and prosper when the market rebounds — which it will do! Investment managers who, in that great British phrase, are “too clever by half” may lose their clients’ support and business. We saw that happen in the United States in the 1990s when certain prominent investment managers were in denial and their clients turned on them.

Let’s look at the investors’ perspective, if these write-downs indeed start to roll in. The obvious questions are: Do you stick with the advisers who created the problem? Who is best qualified to resolve the problem: the firm that made the investment or a “fresh face”? Recently, *The Economist* had an article about Greg Brenneman, a well-respected corporate turnaround specialist (Continental Airlines, Burger King, Quiznos). He had several basic rules for a successful turnaround: First, “stop the bleeding”; that is, fix the immediate problems that are causing the losses. (As they say, “the first rule of holes is stop digging”.) Second, new managers are absolutely essential. As Brenneman puts it: “It’s hard for the same people who put you in the ditch to pull you out of it”. He confesses that he was sometimes slow to do just that to the detriment of his turnaround efforts.

My personal experience in doing corporate and asset workouts in the 1970s and 1980s is essentially the same. It’s very hard for an investor to get what I call “unvarnished and unconflicted advice” from the very people who created the problem. There are simply too many pressures on the existing investment managers to correctly and adequately confront and deal aggressively with the problem: overly rosy PPM (private placement memorandum) projections, tattered client relations, dependence on fees, wavering staff, reputational risk and raw human emotion. They are fundamentally “overly invested” in their investment decisions (pun intended) to be coldly rational.

Some people may be able to morph themselves successfully from an optimistic “investor” to a tough, proactive “workout” specialist, but I have found that to be a rare event. The odds are against it.

An additional complication is that in the “good old days of the 1980s and 1990s” assets were either held directly by investors in separate accounts or in funds that had relatively balanced governance provisions. The more recent funds, however, have, due to the over-exuberance of the investors, governance provisions that are heavily weighted in favour of the fund managers. We may see some fascinating scenarios as investors attempt to

wrestle control of underperforming assets from their fund managers.

Between out-of-balance governance provisions and widely held securitised debt, we may see some real control battles ahead that could make successful workouts even more challenging than in the past.

ENJOYING LIFE

If the slump that I suspect is coming actually does deepen and spread, there will be a need for experienced workout executives. They may not be easy to find. As mentioned above, there are not that many people in the business today who have experienced truly hard times — we simply have had too long a bull market. Many of the workout veterans from the 1980s and 1990s are now out playing golf or otherwise enjoying life.

How, then, will investors find the help they need to resolve their problems, especially if they elect to replace their existing investment managers? They will probably have to lure some of the “experienced hands” back into the fray, so that they can then train new workout managers.

I have found successful workout people to be quite different from bull-market investors, especially those on the acquisition side, who are generally unconstrained optimists. Workout people tend to be a little more cynical and sceptical, as they are constantly confronted with solving difficult problems. The conundrum that investors will face is that, despite their losses, they will need to incentivise their new workout managers.

That is always a tough issue for investors to face, especially public pension boards, but they are more likely to agree to incentives for new investment managers rather than resetting incentives (i.e., lowering benchmarks) for the investment managers who created the problem in the first place.

It’s going to be interesting. As Geoff Dohrmann, the publisher of *The Letter – Europe* and editor-in-chief of Institutional Real Estate, Inc., frequently likes to remind us: “It’s a wacky, wacky world out there”. ♦

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