

## Late 2011 Real Estate Expectations From a Personal View

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As a real estate attorney, I cannot help but consolidate a few thoughts about 2011. First, for any real estate transactions, the impact of the economy on the real estate market means a buyer should not assume that appreciation in value and rents will eliminate problems with the property purchased. Second, with most properties on the market being “problem properties” extraordinary due diligence is required to assure that the problems can be corrected or are at least manageable.

### Economic Stagnation and Real Estate Market

Many economists will acknowledge that there is no real reason why real estate must quickly climb out the recession. It is not simply that the economy has not shown any major improvement in employment, goods or services. Rather, the focus on preventing our financial system from failing due to the past real estate bubble has itself disrupted the real estate market from its natural business cycle, extending the term of the recession. In particular, the current strategy has been to reduce the number of bank failures, wherein banks may retain excessive real estate for longer periods, or have "ghost inventory" (default properties held long-term in the foreclosure process) or, if failure occurs, to shift real estate to another bank. These actions limit the movement of capital and wealth by preventing real estate from being brought back into productive, competitive use. Understandably, there is the fear of another Great Depression. However, the question as to whether this strategy makes good business sense can be well considered in light of the remedies undertaken during the 1991 recession. During that downturn, Congress used tools to actually accelerate the real estate business cycle, including using the Resolution Trust Company to liquidate excess held bank real estate, allowing troubled real estate to more quickly move to new owners who could improve, develop and hold real estate. During that same period, fewer jobs were lost, and new opportunities were created due to the availability of a limited amount of affordable real estate.

### Real Estate Inventory

The effect of this stagnation on the real estate market becomes apparent to the extent that the current real estate inventory available for sale continues for the third successive year to be mostly unhealthy.

*Commercial Property.* With respect to commercial property available for sale, what is coming on the market is often not very desirable. Heavily leveraged commercial property impedes the ability for sellers to reset their real estate to market without banks agreeing to forgive a portion of the loan. In addition, in this environment, buyers are not in a position to assume the seller's debt risk. Accordingly, absent a significant improvement in demand for retail and office space, the ability for a particular property to take on buyer debt may be limited and, accordingly, Buyers need to be prepared to come in with greater equity or demand price concessions

below where sellers are willing to go. This balance between seller and buyer expectations makes real estate sales of commercial properties tricky. While in stronger markets such as in Los Angeles, and in the Bay Area, there are opportunities for deals, they need to be heavily negotiated as to price and many deals simply don't pan out.

*Multifamily.* While the multifamily has not suffered the same vacancy rates, many properties on the market remain unhealthy due to mismanagement or taking on poorly thought out loan programs. Some poorly managed or lower quality properties were quickly foreclosed upon allowing them to move on. On the other hand, for better properties, while banks are now willing to lend, the gap between buyers and sellers as to price remains difficult to close. In a number of cases, we have seen that sellers are demanding sales prices well above the property's current economic value. Whether due to unrealistic expectations, excess debt, or the expectation of cash (to acquire another property), these expectations make completing a deal difficult. In many cases the "good deals" do not reach market, but involve private parties, as brokers endeavor to retain commissions.

*Single Family Residences.* For those who can buy a home, it may be a good opportunity, but for those who are upside down or plan to sell, the home market continues to be troublesome. Single family residences involve a sector slow to recover and one should not bet on appreciation as a basis of purchase. On the other hand, there are some good opportunities, but caution is urged. For example, a Seattle bay view downtown (high-rise) condominium two blocks from Pike's Market recently sold for \$150,000 - a great price for personal use, but the buyer should not expect to resell for a profit anytime soon.

### Due Diligence

Given this environment, buyers should beware of sales offers that have hidden problems. Low interest rates help buyers to accept some problems; it does not make these problems go away wherein properties are being misrepresented as to value.

For example, rent incentives are being used, not as a move-in incentive, but as disguised permanent adjustments, where the scheduled rent is greater than the actual agreed rent to be paid. As another example, obvious deferred maintenance is being found in many better properties, where the sellers simply refuse to acknowledge the problem. If that were not troublesome, with few available better properties, sellers have at times demanded that buyers assume their bad decisions, including vacancies, high loan pay-off (yield maintenance) and other problems.

Accordingly, in this market, if any deal is to happen, buyers have to decide which seller problems to accept, if no good alternatives can be found, and have to ask for price concessions during the due diligence period. In addition, due diligence is critical. As a sample of just some of the additional due diligence steps to consider:

1. As to any property conditions, in addition to a complete walk-through; experts should be retained to identify problems and contractors hired to determine the actual costs of any maintenance concerns.

2. Rent schedules cannot be trusted. The buyer must determine actual expected rental income independent of seller representations: actual tenant rent paid each month (not the tenant's listed rent) must be determined; the market rate for rents; not those represented must be determined; vacancy/absorption rates must be determined.
3. Operating expenses cannot be trusted. The buyer must determine actual operating expenses and not rely on anything Seller represents if low; many sellers have emaciated operating expenses prior to sale due to their current financial positions, and are selling as the property can no longer be maintained.
4. All loan documents must be examined; many sellers are wholly unaware of the yield maintenance requirements and may refuse to close in order to holding buyer hostage to shift problems to buyer.

Given these problems, purchase agreements must allow for extensive due diligence, and an opportunity "to walk" from the deal if the problems are greater than buyer's the commitment to the real estate purchase. Even where the agreement provides for an "as is" acceptance requirement, buyers should be prepared to reject projects during the due diligence, subject to a request for an appropriate price adjustment. In assisting clients, we have been advising clients on both drafting issues and what to do during due diligence when problems are found. Having a good attorney with some common sense ideas helps to complete real estate transactions.