Global CMBS Newsletter

Volume 3, Issue 8, July 3, 2008

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GUNS & MOATS: WHAT WARREN BUFFETT CAN TEACH YOU ABOUT REAL ESTATE

"In business, I look for economic castles protected by unbreachable 'moats'."
-Warren Buffett

We in the real estate business can all learn something from the Oracle of Omaha. One of Mr. Buffett's tenets of investing is that he looks for companies that have a 'moat' that shields them from competition and allows them to earn high rates of return.

A moat is something that creates high barriers to entry for would-be competition. A moat need not be hidden or surreptitious. The strongest moats are when your competitors know your secret but still cannot find a way to copy it. In the commercial real estate sector, barriers to entry are typically economic, physical or political.

Since the early 1990s, nearly every property type and every market has benefited from economic barriers to entry. Essentially, development activity was minimal because the market value for existing space was well below what was necessary to justify new construction. As such, the relevant universe of CMBS performance data was collected in a market devoid of new competition. The bad news is that market rental rates in a number of supply-constrained markets have increased to levels that easily support new development. In a supply-constrained market, property quality is relative to other available options. Tenants in need of space may have little choice but to pay a premium rate for rather ordinary space.

Physically supply-constrained markets can develop moats that preclude competition until rental rates for existing space reach levels that nearly ensure future development. Before rents rise high enough to spur new construction, Class B owners are able to lease space for amounts that would exceed value in an unconstrained market. High rental rates and demand for quality space will encourage Class A construction on existing parcels. When new Class A property becomes available, Class B space will be marked-to-market. It is highly unlikely that Class B leases signed at premium rents will renew at those premium rates as Class A space becomes available for the same rate. A ten-year loan on a Class B building that gets caught in the middle of a construction cycle will have difficulty refinancing. As development activity returns, the economic barriers to entry that existed when the loan was made fall victim to the success of the moat. Seasoned assets struggle to maintain occupancy, facing the harsh reality that their equity has eroded.

Political factors, namely zoning laws, are features of moats as well. While the lack of zoning promotes new construction to some extent, strong zoning laws will help temper new competition. Zoning can lock out competition in the form of land-use and/or height restrictions. A property or piece of land whose zoning designation is distinct from the parcels surrounding it (either from being grandfathered in or through shrewd use of political 'encouragement') has advantages, due to greater land-use options and flexibility. Such an asset can offer a very solid moat until the laws change.

Zoning laws are not carved in stone. Today, many municipalities are adopting anti-sprawl or smart-growth ordinances and plans. Mixed-use properties, a sometimes undefined term, can muddy the conventional zoning definitions. But it is a process. Even if other owners/developers advocate for and receive zoning changes, the rigorous and often lengthy process of gaining a zoning change or variance is often a costly and time-consuming endeavor. While zoning tends not to change rapidly, do not assume the zoning moat that exists today will still be there tomorrow.

Moats are most often found in strong urban or suburban markets; very seldom does a tertiary market have a moat. It takes much less of a system shock to upset a tertiary market than it does a larger market. Land is generally cheap and abundant, and development is welcomed as a source of additional tax revenue. Barriers to entry are low, and thus the moats, if they exist, are shallow, skinny and will likely dry up at the first sign of a drought. Once a default occurs in such a market, the severity of loss greatly increases. As one borrower at this

year’s CMSA said, “If you're over-levered and in a tertiary market, you’re dead.”

Within tertiary markets, however, you may find some ‘guns’, which DBRS defines as real estate assets properly structured to benefit from a captive audience. When financing assets in tertiary markets, one is generally looking for such a captive audience, sometimes referred to as a hostage situation. This can come in the form of a government or credit-rated tenant on a long-term lease with no termination clauses or from an asset with proximity to a specific demand generator with low market volatility, such as hospitals or universities.

Structural features such as low leverage or rapid amortization and anticipated repayment dates are important factors for a gun that can balance the risk associated with remote markets, which are inherently less liquid. A $350/square foot loan for a free-standing national pharmacy chain operating on a 20-year lease will raise eyebrows anywhere. But structuring the loan on a 20- to 25-year amortization schedule is far less risky than a ten-year interest-only loan on the same asset.

Considering the uncertainty in the current and forecasted economic environment among different markets and property types, one should identify and invest in deals concentrated in moat markets by examining the economic, physical and political characteristics. Ask yourself: If they are not in moat markets, can they be classified as guns?

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