

Dearth of Properties Spurs Fund Givebacks

By [LINGLING WEI](#)

Some real-estate funds, which raised billions of dollars hoping to pounce on bargain properties, are returning money to investors after finding slim pickings, as many banks avoid dumping property by extending and restructuring loans.

A slew of private-equity funds, including ones run by [Morgan Stanley](#), Rockpoint Group LLC and Chicago developer John Buck's firm, have taken the unusual step of allowing investors to exit their funding commitments when the funds' investment period expired. A total of 19 private-equity real-estate funds have either returned or plan to return more than \$6 billion of capital to investors, said Real Estate Alert, a trade publication. Others have sought to extend their investment periods or change their investment mandates in light of the short supply.

The private-equity refunds highlight a supply-demand imbalance in the commercial real-estate industry. Investors have accumulated billions of dollars to look for returns in the down-on-its-luck market for office, retail stores, hotels and other commercial property. But not too many properties are for sale, as many real-estate owners are holding onto assets in hopes of a stronger rebound. Property owners have benefited from low interest rates, which keep loan payments low, and banks' reluctance to sell troubled loans.

"Funds are fighting over a slim group of available deals," said Mark Edelstein, head of the real-estate group at law firm Morrison & Foester LLP.



This complex in Littleton, Mass., sold for almost \$90 million, a price that exceeded market expectations.

"Nothing came to the market," said **C. Daniel Clemente**, a Washington developer who recently returned \$1 billion of capital he raised from investors during 2008 to buy distressed properties. "To hold that money any longer just isn't right," he said.

When the recession hit and commercial real estate appeared to be heading for a cliff, funds raised billions of dollars with hopes of repeating what investors like Sam Zell did during the real-estate collapse of the early 1990s. Those investors bought assets from banks that were under pressure from regulators to take write-offs and sell troubled loans. When those assets soared in value later in the decade, they profited handsomely.

These days, however, many lenders, especially community and regional banks, have been restructuring loans at fast clips, partly encouraged by federal guidelines issued last year that give banks more leeway to modify loans to avoid bigger losses. They are avoiding selling troubled assets, hoping to earn their way out of trouble. In the meantime, inventory remains low.

Ultimately, the ability of owners and banks to hold onto properties and not dump them on the market at the worst possible time could keep real-estate prices from falling further and help aid the recovery. But if the loan modifications delay the inevitable defaults, the market could tumble further and the downturn could last longer than it otherwise would.

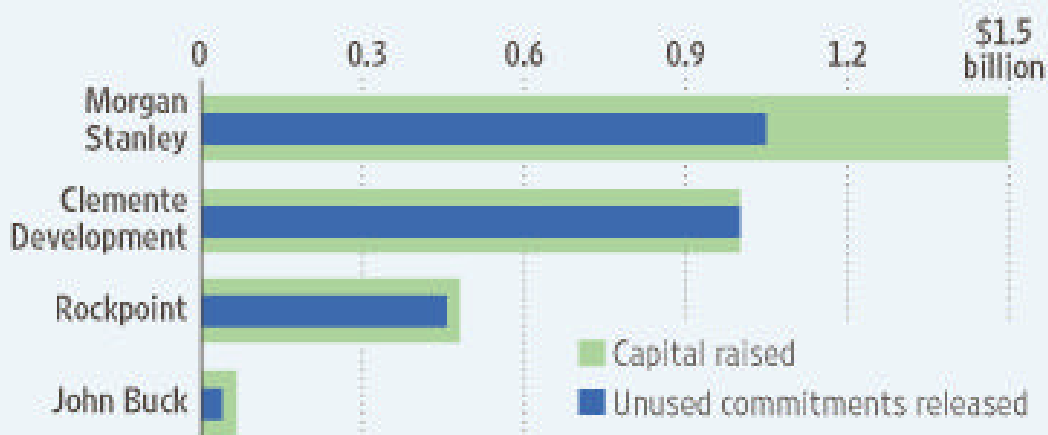
Critics of the strategy, who have dubbed it "extend and pretend," said it ties up bank capital in questionable loans and prevents them from extending new credit.

Morgan Stanley in 2007 raised \$1.5 billion from investors, including the Government of Singapore Investment Corp. and the Teacher Retirement System of Texas, with plans to buy or originate mezzanine debt that has higher risks as well as higher returns than the first mortgages. The fund manager hoped to capitalize on the higher rates it thought that borrowers would pay because of troubles in the debt markets. The idea was to spend the capital quickly in a nine-month investment period, compared with the three- to four-year time frame typical of a real-estate fund.

But the fund found only a few available investments that would justify the kind of risk it took on. As a result, it chose to spend less than 30% of the committed capital even after getting an extension for its investment period. It has released investors from their commitments to the fund.

Real-Estate Refunds

Some private-equity real-estate funds have returned unused commitments to investors because there is little to buy partly because of banks' reluctance to sell troubled commercial-property assets.



Sources: WSJ reporting; Real Estate Alert

According to real-estate research firm Real Capital Analytics, roughly \$31 billion of properties were offered for sale in the first quarter, unchanged from the year-earlier period. By comparison, that figure was almost \$86 billion in the first quarter of 2007, the top of the market.

When properties do go on the block they are typically met with strong interest. A 489,591-square-foot office complex located at 550 King St. in suburban Boston recently sold for almost \$90 million, a price that exceeded market expectations though still lower than what it could have got at the market peak. The Federal Deposit Insurance Corp. also has attracted long lines when it put on the block assets it took over from failed banks.

With so little choice, "There is a risk that if the manager doesn't invest, it must return that money to the investors and lose fees," said Terry Ahern, co-founder of Townsend Group, a real-estate advisory firm that invests on behalf of institutional clients. "The worst event for the investor is for the manager to invest when there are no deals just to place the money and preserve fees."

Another potential incentive for funds to give unused commitments back to investors lies with how fund managers are compensated. The expected returns of the entire fund may fall below the threshold that allows the manager to participate in the profits.

In another case of refunds, a \$480 million high-yield debt fund managed by Rockpoint called only \$24 million of the committed capital to invest in three deals

involving residential developments. The remaining commitments were released to investors. In addition, the John Buck Co. returned \$40 million unused commitments to a \$65 million fund it launched in 2008.

"We spent a great deal of time trying to find prudent investments," said Charles Beaver, a principal at John Buck. But "there was a disconnect between the pricing that was in the market and the return you expected to receive," he said.

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