Last Updated: March 20, 2015

EXCLUSIVE

Ten CRE Investment Strategies for 2015

By Natalie Dolce | National

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WALNUT CREEK, CA—The CRE industry is in the boom times once again. In the exclusive column below, Joseph Ori, executive managing director of Paramount Capital Corp. discusses his firm's top 10 investment strategies for 2015.

The views expressed in the column below are the author's own.

1. Sell Class A Garden and Hi-Rise Apartments.

Class A apartments are one of the most overpriced of all asset classes. According to the Mortgage Bankers Association of American, apartment permits, starts and completions have ramped up significantly during the last few years as follows:

	2012	2013	2014	Total
Permits	285,000	332,000	367,000	984,000
Starts	234,000	294,000	340,000	868,000
Completions	158,000	186,000	256,000	600,000

This additional supply, especially in the hi-beta markets of Dallas, Houston, Austin, Miami, Tampa, Atlanta, Phoenix and Las Vegas is beginning to lead to higher vacancies and lower rents. Even some of the high barrier to entry markets in CA, like San Jose and Walnut Creek, are seeing a lot of new development.

Class A apartments are trading at cap rates of 3.5% to 5% and we don't think they can get much pricier. The average rental rate increases during the last few years of approximately 4%-8% (depending on the location) will begin to decline to a more normal 2% to 3% and values for class A apartments will peak in 2015.

Our suggestion is to sell class A units and recycle the funds into B&C properties in need of renovation and upgrading. These value-add type of properties can be bought at 7%-9% cap rates and in the right market, can significantly increase in value post renovation.

2. Provide Participating Mezzanine Loans.

Even though there is a lot of capital sloshing around chasing deals, there is a dearth of debt/equity capital for the portion of the capital stack above the first mortgage at about 70% and below the owners' equity investment of 10%. This slice of 20% of the capital stack is ideal for a participating mezzanine loan. For example, a 95% leased office building with a net operating income of $1.3 million and worth $20 million at a cap rate of 6.5%, could be structured with a $4 million mezzanine loan as follows.

Description	Amount	Comments
First Mortgage	$14,000,000	5% interest rate, 30 yr. amortization
Mezzanine Loan	4,000,000	10% interest rate, with 6% paid and 4% accrued, 20% participation in cash flow after debt and any capital transaction (sale and refinance) plus 2% in loan fees
Owner Equity	2,000,000	Owner equity investment
Total Capitalization	$20,000,000	

The IRR on a portfolio of participating mezzanine loans should be 15% to 18%, which is higher than a typical CRE fixed income return, due to the higher risk of the transaction and the participation interest. The mezzanine lender is taking some of the equity risk and should be compensated for such. The mezzanine lender will most likely not be able to lien the property and instead have to rely on a guarantee from the owner and a pledge of the owners' equity interest in the property as security.

3. Provide Private Equity Capital to Commercial Real Estate Developers.

CRE development is beginning to ramp up and is on the up-slope of the property development cycle curve. Developers of office, retail, industrial and medical properties need equity capital at the property and corporate level. Providers of this capital can take advantage of the vibrant construction cycle, lower cost and higher returns from development versus the acquisition of similar property and friendly lending markets. If the developer is privately owned and has a large regional or national presence, the exit strategy for the capital providers may be a public REIT or sale to a REIT or institutional investor.

4. Sell Portfolios of Single Family Homes.

This is a low margin, volatile business with high costs and unwieldy management. If interest rates begin to rise, home values will fall, cap rates and the cost of capital will increase, which will compress returns. Most of the publicly traded single family REITs have underperformed the market as shown in the following table.

REIT	12/14 Return	1 Year Return	Current Stock Price	Dividend Yield	Market Capitalization
American Homes 4 Rent (AMH)	-.7	6.35%	$16.51	1.2%	$3,49B
Altisource Residential (RESI)	-1.67%	-30.02%	$17.85	12.4%	$1.02B
Silber Bay Realty Trust (SBY)	-.06%	4.58%	$15.57	1.5%	$581.4M
American Residential Properties, Inc. (ARPI)	-1.13%	2.39%	$17.34	None	$557.3M
Starwood Waypoint Residential Trust (SWAY)	4%	-6.49%	$24.02	2.3%	$907.3M

5. Provide Investment and Growth Capital to CRE Crowdfunding sites.

Crowdfunding sites that raise debt and equity capital for CRE deals are growing fast and taking an increasing share of the small property funding market. We believe this sector of real estate funding is here to stay and will grow as the democratization of capital becomes more commonplace. There are more than 50 of these sites, however, many of the principals do not have the requisite experience in CRE, finance and the capital markets to be successful. We would recommend only investing in firms that have experienced senior level personnel that have been in the industry a long time and have a solid track record of completing real estate deals. We also think that this sector of the real estate capital market will consolidate in the next few years and there will be opportunities for capital providers to profit from this consolidation.

6. Perform a Systematic Review and Analysis of the 15 CRE Risks.

There are 15 risks inherent in investing in CRE as follows:

- Cash Flow Risk-volatility in the property's net operating income or cash flow.
- Property Value Risk-a reduction in a property's value.
- Tenant Risk-loss or bankruptcy of a major tenant.
- Market Risk-negative changes in the local real estate market or metropolitan statistical area.
- Economic Risk-negative changes in the macro economy.
- Interest Rate Risk-an increase in interest rates.
- Inflation Risk-an increase in inflation.
- Leasing Risk-inability to lease vacant space or a drop in lease rates.
- Management Risk-poor management policy and operations.
- Ownership Risk-loss of critical personnel of owner or sponsor.
- Legal and Title Risk-adverse legal issues and claims on title.
- Construction Risk-development delays, cessation of construction, financial distress of general contractor or sub-contractors and payment defaults.
- Entitlement Risk-inability or delay in obtaining project entitlements.
- Liquidity Risk-inability to sell property or convert equity value into cash.
- Refinancing Risk-inability to refinance property.

All investors that own CRE should perform a detailed and systematic review of the above risks and their potential effect on an asset or portfolio. An easy way to perform this review is to assign points for each property based on one of three risk levels that correspond with each of the 15 risks. For example zero points for no risk, one point for moderate risk and two points for high risk. The cumulative risk rating for the property can then be calculated. If the property is subject to all 15 risks and the rating is zero to 10, the property has minimal risk, 11 to 20, there is moderate risk and 21 and over is high risk. Once the total risk factor is known, ownership can take the necessary steps to mitigate or eliminate each risk.

7. Provide Capital to CMBS Issuers or Invest in the Securities.

The CMBS business is coming back strongly and the industry, which was virtually closed down from 2008 to 2011, is in need of new corporate capital and warehouse line to establish and grow the business. The volume of new CMBS securities during the last few years was, 2012-$44 billion, 2013-$80 billion and 2014-$90 billion. CMBS production for 2015 is projected at more than $100 billion. This sector is in dire need of new capital and loan originators. A growing and established CMBS market is critical for a healthy CRE industry and will prolong the boom times.

8. Sell Class A Properties in Core Markets.

Owners of Class A properties in core markets like, New York, San Francisco, Miami, Boston and Seattle should consider selling their properties at these historically low cap rates and reinvest the proceeds in second tier markets at higher risk adjusted returns. Profits can be recycled into smaller growth markets like, Oak Brook, IL, Walnut Creek, CA, Tucson, AZ, Albuquerque, NM and others. These small second tier cites have solid demographics and offer higher risk adjusted cap rates than the overpriced core markets.

9. Acquire Small capitalization Public and Private REITs.

There are more than 30 public REITs with market capitalizations less than $1 billion that are trading at or less than their net asset value. These REITs are ripe to be acquired or taken private by other REITs, real estate private equity firms or other institutional investors. It also may be possible to get control of the board of directors of some of these REITs via a proxy contest as was done by Corvex, a private equity firm that ousted the former management of office building REIT, Commonwealth REIT and gained control of the company.

Any acquisition or merger opportunity will have to comply with the REIT tax rules including, the 5 or 50 rule which states that 5 or fewer individuals cannot own more than 50% of the value of a REIT during the last half of the year. Also, more than two thirds of REITs are incorporated in the state of Maryland which has broader liability protection, more flexible voting provisions for stockholders, easier bylaw amendment provisions, and better protection against hostile takeovers and easier stock issuance procedures. Notwithstanding a Maryland incorporation, there are still opportunities via a friendly acquisition or proxy contest.

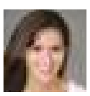
10. Reduce Allocation to U.S. Equity REITs and Increase Allocation to International REITs.

The total returns of U.S. REIT stocks has been very good the last few years and all investors, individuals and institutions should have an allocation of 5%-15% to REIT stocks. If interest rates begin to rise in the U.S., then investors consider selling some of the pricey U.S. REITs and reinvest the proceeds into international REIT stocks. International REIT stocks have generated an average annual return of 40.6% during the last five years. Allocating investment funds to International REIT stocks provides low correlation to the investment portfolio which reduces nonsystematic risk and increases returns.

Currently, there at 30 countries outside the US with established REIT markets and stocks and four countries, including China, which are considering establishing a REIT market. The table below shows the total returns and market capitalization of companies representing the US REIT market by the FTSE NAREIT All Equity REIT Index and the non-US REIT market by the FTSE EPRA/NAREIT Global Ex US REIT Index.

Index	1 Yr. Return	3 Yr. Return	5 Yr. Return	Market Capitalization	Dividend Yield
FTSE NAREIT All Equity REITs	27.15%	16.39%	16.63%	$907B	3.56%
FTSE EPRA/NAREIT Global Ex U.S.	3.6%	47.1%	40.6%	$736B	3.3%

About Our Columnist



Natalie Dolce, national executive editor of GlobeSt.com, is responsible for working with editorial staff, freelancers and senior management to help plan the overarching vision that encompasses GlobeSt.com, including short-term and long-term goals for the website, how content integrates through the company's other product lines and the overall quality of content. Previously she served as editor of the West Coast region for GlobeSt.com and *Real Estate Forum*, and was responsible for coverage of news and information pertaining to that vital real estate region. Prior to moving out to the Southern California office, Natalie was Northeast bureau chief, covering New York City for GlobeSt. Dolce's background includes a stint at *InStyle Magazine*, and as managing editor with *New York Press*, an alternative weekly New York City paper. In her career, she has also covered a variety of beats for *M* magazine, *Arthur Frommer's Budget Travel*, FashionLedge.com, *Co-Ed* magazine and the *Daily Orange* newspaper. Dolce has also freelanced for a number of publications, including MSNBC.com and *Museums New York* magazine.

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