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Entrepreneurial Investors Get Creative to Find Higher Returns

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From Wall Street to Main Street, real estate has become a more attractive investment alternative, spurred in large part by positive market fundamentals, historically low interest rates and the growing and active presence of **commercial mortgage-backed securities (CMBS)** debt. The market is flush with capital that is readily available from a growing horde of aggressive new investors and lenders, including **hedge funds**, **subordinate debt investors**, and **commercial finance companies**.

Strong property market performance and abundant liquidity, however, has created certain challenges for real estate investors. While a boon to borrowers, who have been able to negotiate more favorable loan terms and leverage, the **intense competition** and **aggressive pricing** has compressed investors' margins and risk-adjusted returns. Entrepreneurs especially have had to rethink their investment strategies, since traditional value-added opportunities – for example, buying partially-leased buildings and bringing occupancy to market levels – have become pricey and scarce.

To address the shallow pool of value-added investment opportunities, entrepreneurial investors have had to get more creative to find deals that will deliver the higher returns they seek. One trend we have seen in recent months is that entrepreneurs are more willing to pursue development-oriented projects. Ground-up construction lending is on the rise for hotels, mixed-use facilities and multi-family properties. While the for-sale residential sector has begun to retrench, we have selectively originated land banking transactions in which we finance an intermediary, which owns land that has been pre-sold to a national homebuilder.

A related investment trend that demonstrates out-of-the-box thinking is the deep, often radical repositioning of aging or out-of-favor facilities. For example, we have seen an increased appetite for adaptive reuse of **commercial buildings to hospitality**, particularly in densely populated cities such as **New York** and **Chicago**.

Another example of **creative repositioning** occurred in a Florida coastal city, where a real estate sponsor purchased a vacant **office building** with the intent of converting it to **residential condominiums**. However, as interest rates inched upward and rented apartments became a more affordable and attractive option, the entrepreneur switched gears and decided to develop this commercial building as a for-rent multifamily property. Because the property acquisition basis was attractive, the sponsor was able to gut the building and create a like-new multifamily property at competitive rents.

Another trend that has been gaining momentum is traditional lenders' move into niche markets such as **self-storage**, **commercial condos** and **recreational vehicle (RV) parks**. We've recently completed three commercial condo deals that cover the full spectrum of the development cycle--one was a ground-up construction, another was a complete renovation of a vacant building and the third was a conversion of an **85 percent** leased office building.

An even more esoteric market niche – occupied by real estate entrepreneurs who bring a "traders" approach to their real estate investments – offers an unusual arbitrage opportunity. Here's how this works. An investor buys a portfolio of net lease retail properties, such as nationally branded fast-food outlets from an owner-operator desirous of shedding their real estate assets from their balance sheets. These portfolios are often acquired in bulk at wholesale costs. The business plan is to quickly sell the individual assets, on a one-off basis typically to **1031 Exchange** buyers.

What's made these and other innovative approaches to real estate investment possible has been the widespread application and acceptance of more sophisticated financial instruments. Thanks in large part to CMBS in the real estate capital markets, specific and detailed property and market data have become more available -- always a good thing for investors. Market liquidity issues may subside in the near future as rising interest rates could cause a retraction in CMBS activity. Market transparency, however, is here to stay, and creative entrepreneurs will continue to leverage their knowledge and expertise in sourcing and capitalizing on new types of investment opportunities.

CapitalSource is a specialized commercial finance company offering asset-based, senior, cash flow and mezzanine financing to small and mid-sized borrowers through three focused lending units: Corporate Finance, Healthcare Finance and Structured Finance. By offering a broad array of financial products, CapitalSource has issued more than $9.6 billion in loan commitments. Kelly can be reached at ckelly@capitalsource.com.