Dealing with Vacant & Obsolete Commercial & Industrial Buildings

February 3, 2011

Kent Carlson
Tim McShane – McShane Development
Murray Kornberg – CBRE Capital Markets

INTRO

- Kent Carlson
  - 25 years of development experience
  - 500 acres of business park development experience
  - Over 3,000,000 square feet of construction activity
  - Thank you to First Industrial/Welsh Companies for our case study
INTRO

- **Tim McShane**
  - 25 years of development experience
  - $200,000,000 in asset value
  - Over 2,900,000 square feet of construction activity
  - Thank you to Reliance Development for our case study

- **Murray Kornberg**
  - 25 years of development and financing experience
  - Involved in closing over 250 real estate loan transactions
  - Aggregate dollar amount in excess of $2.5 Billion
Overview

- Understanding public/private partnership goals
- Current market conditions
- Industrial building repositioning
- Retail building repositioning

UNDERSTANDING PUBLIC/PRIVATE PARTNERSHIP GOALS
PUBLIC / PRIVATE PARTNERSHIP GOALS

- Job growth
- Keeping existing businesses healthy
- Maintaining a strong tax base
- Diversifying and expanding businesses
- Vibrancy for our communities

UNDERSTAND COMMUNITY ASSETS

- Workforce
- Area amenities
- Technical expertise
- Tools to help business grow and expand
- Taxing authority
COMMUNITY TOOLS

- Training programs and grants
- Tax abatement during repositioning/redevelopment
- Tax Increment tools during redevelopment
- Low cost financing for improvements
- Appropriate assessment levels

CURRENT MARKET CONDITIONS
CURRENT LABOR MARKET

- National unemployment 9.7%
- MN unemployment 7.1%
- In 2009 MN had 300,000 mfg jobs with growth in 2010 of 3.8%
- Forecast of 4.5 million new jobs nationally in the next 3 years
- Total U.S. loss of jobs during this recession = 8.4 million

CURRENT INDUSTRIAL MARKET

- Overall U.S. industrial market vacancy rate = 11.2%
- Twin Cities industrial market vacancy rate = 12.5%
- 2010 Twin Cities industrial absorption = 600,000 s.f.
- Forecasted 2011 Twin Cities industrial absorption = 800,000 to 1,000,000 s.f.
INDUSTRIAL BUILDING REPOSITIONING

MAPLE GROVE CASE STUDY
93rd Avenue Industrial Center

- Overview
  - 175,000 sf office and manufacturing space
  - Heavy power = 3,000 amps
  - 20’ clear height
  - Land for expansion
MAPLE GROVE CASE STUDY

- Former tenant relocated manufacturing to Mexico
- Building needed updating
- Creative eye for repositioning asset
- Significant capital for improvements
MAPLE GROVE CASE STUDY

- Community Risk
  - Loss of quality manufacturing jobs
  - Building values decline
  - Real estate tax decline
  - Suppliers suffer with loss of manufacturing operations

MAPLE GROVE CASE STUDY

- Repositioning the Asset
  - First Industrial took the risk
  - Creative design options
  - Willingness to multi-tenant as required
  - First Industrial has access to capital for improvements
Repositioning the Asset (cont’d)

- New exterior image
- Expanded office space to meet tenant’s need
- Expanded manufacturing space to meet tenant’s need
MAPLE GROVE CASE STUDY

- Reporting the Results
  - Caterpillar leased for 2 business units
    - Paving Products Division = 118,000 s.f.
    - Paving Products Training & Equipment Operation = 57,000 s.f.
  - 150 new and relocated full-time employees
MAPLE GROVE CASE STUDY

Reporting the Results (cont’d)

✓ Long term commitment to the building
  ▪ Increase market value of asset
  ▪ Increase real estate taxes
  ▪ Additional demand for existing and new Caterpillar suppliers

CURRENT RETAIL MARKET CONDITIONS
### CURRENT RETAIL MARKET

- Twin Cities retail market vacancy rate
  - 2008: 7.9% 8.9%*
  - 2009: 10.1% 11.4%*
  - 2010: 9.8% 11.1%*

  * Includes subleased space

### TWIN CITIES RETAIL ABSORPTION

<table>
<thead>
<tr>
<th>Year</th>
<th>Absorption</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>3,170,000 s.f.</td>
</tr>
<tr>
<td>2006</td>
<td>3,100,000 s.f.</td>
</tr>
<tr>
<td>2007</td>
<td>1,300,000 s.f.</td>
</tr>
<tr>
<td>2008</td>
<td>365,000 s.f.</td>
</tr>
<tr>
<td>2009</td>
<td>-203,000 s.f.</td>
</tr>
<tr>
<td>2010</td>
<td>256,000 s.f.</td>
</tr>
<tr>
<td>2011*</td>
<td>700,000 – 800,000 s.f.</td>
</tr>
</tbody>
</table>

* Projected
Current Retail Market (cont’d)

- Bankruptcies added to available space
  - Circuit City
  - Linen’s & Things
  - Comp USA
  - Hollywood Video
  - Blockbuster

Current Retail Market (cont’d)

- Developer Challenges
  - Existing vacancies
  - Rental rates don’t support new development
  - Financing still a challenge
  - Tenant bankruptcies
  - Request for rent reductions
  - Capital depletion
CURRENT RETAIL MARKET (cont’d)

- New development will be user driven, and only then, if they can’t find existing space

- Risk-based development will only happen after development challenges are resolved and consumer confidence and jobs creep back into the equation - 3 to 5 years

RETAIL BUILDING REPOSITIONING
Dunkirk & 93rd Avenue

Overview
- 136,000 sf
- Big Box retailer relocated
- Reliance Development purchases building with tenant “in hand”
- Deal with tenant falls apart 1 week before closing
- NOW WHAT!!
- Good news - NOT a failed location (repositioning)
RETAIL CASE STUDY

- **Challenges**
  - Technology changing retail landscape;
  - most retailers designing smaller prototypes
  - Must define new market – users
  - Building 300 feet deep; too deep, not suitable for market
  - Building values decreased in downturn
  - OEA in place with neighboring tenant
  - Creative eye for repositioning asset
  - Significant capital needed for improvements

- **Community Risk**
  - Loss of retail jobs
  - Building values decline
  - Real estate tax decline
  - Retail synergies diminished – loss of sales for neighboring tenants
  - Diminished vibrancy for community
### Repositioning the Asset

- **Reliance Development** took the risk
- Creative site design options
- Willingness to multi-tenant as required
- Reliance puts additional capital at risk for improvements
- Re-allocate taxes based on value of resulting uses

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### Repositioning the Asset (cont’d)

- Reuse of Big Box - back half redesigned for storage resulting in reduced parking requirement
- Created opportunity for outlots
Reporting the Results

- Created 5 outlots
  - Sold outlot to national tire company
  - Sold outlot to national oil/lube company
- Developing back 50,000 s.f. for state of the art, drive-in/through, climate controlled, self storage – hired management firm to run business
- In negotiations with new 30,000 s.f. retail tenant for portion of front half of building
- Created leasable mezzanine space to add value

PUD – allowed flexibility; more marketable
Increase market value of asset
Increase real estate taxes
Additional demand/synergy for neighboring tenants
Added amenities/vitality for the community
New jobs!

Maple Grove city staff very creative & cooperative
SUMMARY OF PUBLIC / PRIVATE PARTNERSHIP TOOLS

- Reduce real estate taxes during repositioning
- Look for training programs and grants to assist with the marketing effort
- Review potential of setting aside existing development obligations during repositioning
- Assess properties appropriately

LENDOR INVOLVEMENT DURING REPOSITIONING
Overview

- Debt Market Overview
- Distressed Market Overview
- Equity Market Overview
- Know the Lender
- Conclusions and Action Plan

DEBT MARKET OVERVIEW
KEY THEMES

- Looming maturities outstrip new origination capacity, tsunami of distress not likely though
- Sales transaction volume expected to reach 2003/2004 levels as activity improves
- Lenders will play “harder ball” in the coming months driving more sales activity
- CMBS 2.0 here now, 18 “new” lenders looking for loans to “balance sheet” for securitization
- Huge compression in debt spreads over the past 3 months, underwriting standards relaxed, fundamentals stabilized

KEY THEMES (cont’d)

- Investors still like commercial real estate (REIT’s raising huge amounts of capital, foreign buyers active)
- Trophy assets being sold to investors focused on cash yield/ IRR
- Trauma investors looking at low basis and stabilized return on cost
- Note value & real estate value very similar
- “Scarcity Premium” exists for well leased, high quality assets
- Low debt cost may compress cap rates further on high quality real estate
THE WAVE OF REFINANCINGS: SHORT-TERM PROBLEMS LOOM

The wave of refinancings represents "core" CRE loans on income-producing properties. An additional $400 billion of construction and real estate development loans are on bank and thrift books.

WHERE ARE WE NOW?

- U.S. Investment Market
  - 3Q market wide sales volume up 115% from a year ago to $28.9 billion
  - 3Q10 YTD market wide sales volume off 82.8% vs. 3Q07 YTD Peak
  - Lack of return in other asset classes, primary driver for buyers
WHERE ARE WE NOW?

- **U.S. Investment Market (cont’d)**
  - Equity markets rebounding (at the moment)
  - Pricing has increased by 25% from the bottom with cap rates tightening 100-150 bps for yield profile deals (still down 15-20% from peak values)

WHERE ARE WE NOW?

- **U.S. Debt Market**
  - Spreads on commercial 200+/- over 10-year treasury with 60-75% LTV and little I/O
  - 4-5% - 75-80% LTV Liquidity and lack of yield have pushed spreads tighter in every asset class – even with record low treasury yields
THE BOOM N’ BUST LED BY CMBS ISSUANCE

Vintage Loans: High % Interest Only
High LTV
Lower DCR

'05 – '08 ($615 Billion total Volume)
Seven years of business in three years!

$7.2B YTD

TOTAL $3.24 Trillion

By Capital Source

Commercial Banks: 79%
Life Insurance Companies: 45%
Savings Institutions: 20.1%
Agency- and GSE-backed mortgage pools: 5.5%
CMBS, CDO, and other ABS issues: 9.6%
State and Local Government: 9.2%
Other: 27%

Source: Commercial Mortgage Alert October 2010

Source: Mortgage Bankers Association 2Q 2010
### WHAT’S IN & WHAT’S OUT

<table>
<thead>
<tr>
<th>IN</th>
<th>OUT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life Company/Agency Lending</td>
<td>TALF</td>
</tr>
<tr>
<td>Vanilla CMBS Lending</td>
<td>Aggressive CMBS Issuance</td>
</tr>
<tr>
<td>Conservative Leverage</td>
<td>High Octane Capital Stack</td>
</tr>
<tr>
<td>Equity In-Deal</td>
<td>Cash Out Financing</td>
</tr>
<tr>
<td>Risk Based Pricing</td>
<td>Inefficient Pricing of Capital</td>
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<tr>
<td>Correspondent &amp; Relationship Lending</td>
<td>Loan Brokerage</td>
</tr>
<tr>
<td>High Touch Loan Servicer</td>
<td>Securitized/Impersonal Servicer</td>
</tr>
<tr>
<td>Amortization-25-30 Year Schedule</td>
<td>Interest Only</td>
</tr>
<tr>
<td>Reserves Funded in Cash</td>
<td>No Funded Escrow</td>
</tr>
<tr>
<td>200 +/- Spreads</td>
<td>100 +/- Spreads</td>
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<tr>
<td>Floor Rates</td>
<td>Unlimited Float</td>
</tr>
<tr>
<td>DCR’s In-Place</td>
<td>Proforma DCR’s</td>
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<tr>
<td>Partial Recourse</td>
<td>Non-recourse</td>
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</tbody>
</table>

### YESTERDAY, TODAY AND TOMORROW

#### Market is De-Leveraging: What will 2011 Look Like?

- **2007**: A-Note 65%, B-Note 15%, Mezzanine 10%, Equity 8%
  - Total Value: $80 million
  - First Trust: $39 million
- **2009**: A-Note 45%, B-Note 15%, Mezzanine 55%
  - Total Value: $52.5 million
  - First Trust: $26.5 million
- **2011**: A-Note 55%, Mezzanine 10%, Equity 10%
  - Total Value: $80 million
  - First Trust: $39 million

Source: Mortgage Bankers Association, CBRE EA
## LESS CREDIT AVAILABLE: MORE EQUITY REQUIRED

<table>
<thead>
<tr>
<th></th>
<th>2007 Peak</th>
<th>2009 Trough</th>
<th>2011 Outlook</th>
</tr>
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<tbody>
<tr>
<td><strong>Net Operating Income</strong></td>
<td>$2,400,000</td>
<td>$2,400,000</td>
<td>$2,400,000</td>
</tr>
<tr>
<td><strong>Capitalization Rate</strong></td>
<td>6.00%</td>
<td>8.00%</td>
<td>7.50%</td>
</tr>
<tr>
<td><strong>Asset Value</strong></td>
<td>$40,000,000</td>
<td>$30,000,000</td>
<td>$32,000,000</td>
</tr>
<tr>
<td><strong>10-year Treasury Rate</strong></td>
<td>4.63%</td>
<td>3.62%</td>
<td>2.75%</td>
</tr>
<tr>
<td><strong>Spread</strong></td>
<td>1.20%</td>
<td>3.00%</td>
<td>2.25%</td>
</tr>
<tr>
<td><strong>Rate</strong></td>
<td>5.83%</td>
<td>6.62%</td>
<td>5.00%</td>
</tr>
<tr>
<td><strong>Years of Amortization</strong></td>
<td>0</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td><strong>Loan Constant</strong></td>
<td>5.83%</td>
<td>8.19%</td>
<td>6.44%</td>
</tr>
<tr>
<td><strong>Maximum Loan to Value</strong></td>
<td>80%</td>
<td>65%</td>
<td>70%</td>
</tr>
<tr>
<td><strong>Minimum DSCR</strong></td>
<td>1.15</td>
<td>1.30</td>
<td>1.25</td>
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<th>2011 Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum Loan Proceeds based on Valuation</td>
<td>$32,000,000</td>
<td>$19,500,000</td>
<td>$22,400,000</td>
</tr>
<tr>
<td>Maximum Loan Proceeds based on DSCR</td>
<td>$35,796,853</td>
<td>$22,534,143</td>
<td>$29,805,059</td>
</tr>
<tr>
<td>Maximum Loan Proceeds (lesser amount)</td>
<td>$32,000,000</td>
<td>$19,500,000</td>
<td>$22,400,000</td>
</tr>
<tr>
<td>Cash Flow after Debt Service</td>
<td>$534,400</td>
<td>$802,424</td>
<td>$957,023</td>
</tr>
<tr>
<td>Equity Required</td>
<td>$8,000,000</td>
<td>$10,500,000</td>
<td>$9,600,000</td>
</tr>
</tbody>
</table>

Source: CBRE Capital Markets

## DISTRESSED MARKET OVERVIEW
U.S. DISTRESSED MARKET VOLUME

$150.9B TROUBLED

$58.6B RESOLVED

$47.3B RESTRUCTURED EXTENDED

$186.5B CURRENT DISTRESSED

$35.6B LENDER REO

Troubled Assets

- **Loans**
  - Delinquent/Default
  - In Foreclosure/Administration
  - Funding Stop
  - Maturity Default/Past Due

- **Property**
  - Challenged Development
  - Tenant Bankrupt
  - Underperforming Conversion or Redevelopment

Source: RCA Troubled Assets Radar, December 2010
- **Troubled Assets (cont’d)**
  - Owner
    - Fraud Alleged
    - Owner Financially Challenged
    - Owner/GP Bankrupt

- **Distressed Assets**
  - Troubled Assets (above) + Lender REO

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**OFFICE CONTINUES TO LEAD IN DISTRESSED MARKET**

Total Estimated Value of 186.2B (10,754 Properties)

- Office 25%
- Multi-Housing 20%
- Retail 13%
- Hotel 18%
- Development & Other 16%
- Industrial 5%
- Other 2%

Source: RCA Troubled Assets Radar, December 2010
DISTRESS ACROSS THE U.S.

The commercial real estate market is improving at a modest pace, but newly troubled properties continue to enter the distress pool.

Source: RCA Troubled Assets Radar, December 2010 – Bubbles are sized to relative distress values
The Metros below account for 65% of distressed and potentially troubled assets:

Source: CBRE-EA, RCA Troubled Assets Radar, October 2010

EQUITY MARKET OVERVIEW
Know the Lender

Bank

- Relying on the Borrower’s Balance Sheet to keep the project current, and ultimately, for repayment
- Concerned not only with the troubled asset, but their Borrower’s global cashflows
- Under pressure from regulators to clean up problem loans, but also under public pressure to make new loans
- Sometimes a loan extension for workout purposes is viewed more favorably than a foreclosure
LIFE COMPANY (cont’d)

- Probably a non-recourse loan (no personal guarantees other than for “bad boy” acts)
- More likely to take action, especially if they can’t see a “light at the end of the tunnel”
- Have the capability (but maybe not the desire) to own and manage the asset to create additional value

CMBS

- Will be slower to react because of loan servicing structure
- More difficult to get a hold of
- More segmented decision making process
- Loan modifications and work-outs governed by securities laws
CONCLUSIONS AND ACTION PLAN

CONCLUSIONS

- You may have a new partner in the transaction that you didn't previously consider
- Understanding that “partner's” motivations is critical
- All other things being equal (no fraud, lying, cheating or stealing) the current borrower might still have the best alignment of interest with the lender in order to preserve their equity and the loan value
- All sides will be looking to maximize the value of the asset
ACTION PLAN

- Find out from your developer how they capitalized their property
- If there’s a development agreement, you probably already have some sort of written agreement with the lender – review and understand those terms
- Find common ground on development agreement/financial terms that can help preserve value

Questions?

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