

Observations on NREI Article

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Featured Article:

“Faltering Property Values Hamper Commercial Mortgage Re-financing Efforts National Real Estate Investor”

August 5, 2009, By Sibley Fleming

While there’s been a lot of buzz surrounding the “2011 issue” — a term coined by commercial real estate experts in reference to \$296 billion in maturing loans originated in 2006 and 2007— refinancing some \$250 billion in loans coming due this year holds no shortage of drama.

The percentage of foreclosed commercial mortgages held by banks at the end of the second quarter more than doubled to roughly 4.3%, or \$7 billion total, compared with a year earlier, according to estimates by Foresight Analytics. The research firm projects that percentage to reach 4.6% by the end of 2009.

As valuations and net operating income continue to decline and debt financing remains scarce, borrowers are feeling the pinch. Valuations are reaping the most havoc on maturing loans. Since peaking in October 2007, asset values have plummeted 29.5% year-to-date through April, according to the Moody’s/REAL Commercial Property Price Index.

In Washington, D.C. and beyond the beltway, lawmakers and policy-makers are beginning to realize the corrosive effects of a weak commercial real estate market. Janet Yellen, president of the Federal Reserve Bank of San Francisco, has underscored the important role valuations play in the refinancing the mountains of maturing commercial mortgage debt.

“The next area of significant vulnerability for the banking system, particularly for community and regional banks with real estate concentrations, is income-producing office, warehouse, and retail commercial property,” remarked Yellen during a banking conference in Idaho last week.

“Our biggest concern now is with maturing loans on depreciated commercial properties,” Yellen added. “In many cases, borrowers seeking to refinance will be expected to provide additional equity and to have underwriting and pricing adjusted to reflect current market conditions... the economic forces hammering commercial property are unlikely to reverse anytime soon.”

There is also “a decent chunk of loans in limbo,” says Matt Anderson, a partner with Oakland, Calif.-based research firm Foresight Analytics. The \$38 billion in defaulted loans held by banks is far greater than the amount in foreclosure estimated at \$7 billion.

Anderson also notes that many lenders view the decline in real estate valuations as a past-tense event, and are not recognizing that property values are likely to be even lower next year than they are now. Compounding the problem is that efforts by the federal government to prop up the financial system may have emboldened lenders to wait for some type of support that would boost prices and prevent waves of steep losses to their balance sheets.

“What’s problematic about [allowing loans to go into foreclosure], particularly for banks, is that the transaction market is so incredibly weak and the pricing on forced sales is so low,” says Sam Chandan, president and chief economist of Real Estate Econometrics based in New York.

Case in point: Worldwide Plaza, a Manhattan office tower, last month sold at a 65% discount from its peak price. In the transaction, developer Harry Macklowe paid \$1.74 billion for Worldwide Plaza, which fell into the hands of Deutsche Bank through foreclosure and was then sold to a new owner in July for \$600 million. “In that situation, banks are loath to actually take control of these properties,” points out Chandan.

Given the lack of available debt, Chandan says that 30% to 40% of the \$250 billion in maturing loans this year has the potential to default. However, he does not believe that the U.S. banks, particularly regional and community banks that hold 50% to 60% of outstanding commercial mortgages on their balance sheets, take it for granted that the U.S. government will come to their rescue.

The implementation of the PIPP Legacy Loan Program, for instance, tasked to remove troubled loans and other assets from bank balance sheets, has been delayed multiple times.

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“The first test of the funding mechanism has just occurred, but it’s really not clear how the program will be implemented, or who it will be designed to help,” explains Chandan.

That could pose a problem for community and regional banks, whose individual failures don’t present nearly the same threat to the U.S. financial system as troubled insurer AIG, for instance. “It’s not clear that the legacy loan program will extend to encompass their needs as well. They’re not systematically important.”

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We feel that the important points of the article and some of our observations as they relate to prospective opportunities to buy assets from distressed sellers can be summarized as follows:

- 1) While the loan balances quoted in this article are not precisely the same as the numbers from the Mortgage Bankers Association, they are large and meaningful. Whether this year’s loan maturities amount to \$220 Billion, as the MBA claims, or the \$250 Billion claimed in the article is secondary to the fact that there are many billions coming due over the next three to four years. About half are CMBS issuances, which because of their highly fractured nature, require more definitive, less flexible action on the part of the special servicers of those loans.
- 2) We have seen restraint by lending institutions to date, but pressure on the banks and life companies to clean up their balance sheets will push them to act on delinquencies. As the federal government better defines its role in this, lenders will be more certain about their remedies as well. CMBS special servicers will have to act on their agreements with borrowers and on behalf of all bond holders in an equal fashion.
- 3) As of late we have observed more foreclosure property coming to market, but it has principally been in harder hit areas like Michigan and properties that are lower grade. We see a progression toward higher quality assets as the aforementioned pressures mount.

- 4) While lenders are holding back on foreclosures, perhaps to see what the federal government may do to mitigate the problems in commercial real estate as mentioned in the article, we feel that they do recognize the potential costs of government assistance.
- 5) The Public-Private Investment Partners program (PPIP) has had numerous fits and starts. The program, as it stands, is principally aimed at newer issues of top-rated CMBS securities. Half the program aimed at bank loan assets is stalled. Banks are now allowed to forestall recognition of losses on loans as long as they are not sold. This is a “finger in the dike” solution to avoiding a stress test failure.
- 6) Even if PPIP ever gets off the ground, purchasers of debt issues will have to push for sales of the underlying assets to realize a return of capital and a source of funds to repay government loans. Borrowers that have high debt levels against declining property values will not be able to refinance these loans.

We fully expect for there to be some year end selling activity with more to follow next year. Prices are being established on the few transactions taking place and will be more firmly so as sales are forced to happen. We continue to believe that cap rates will rise to levels above historic means for a period of time before returning to those mean rates in two to four years. We will be buyers at historically high cap rates, with opportunities to add value through accretive leasing, and then be sellers as cap rates return to more normal rates, albeit not as low as recent history.

If you have any questions, please feel free to contact Larry Reed or Rob Sherwood. Thank you.