Special Report

Have We Hit Bottom Yet?

Commercial Real Estate: A Looming Crisis

September 2009

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Even though many prognosticators are optimistic that we could be at the end of what has become known as the "Great Recession," there are disturbing signs that suggest America is about to confront the possible collapse of the commercial real estate market—represented by $6 trillion plus in total asset value, and supported by $3.5 trillion in debt. Be prepared!

Owners and developers of office and residential buildings, stores, hotels and other commercial real estate are coming under greatly increased pressure to meet their debt obligations. Sharply falling rents, mounting vacancies, and unfinished, abandoned projects across the country have raised genuine concern among banks, other lenders and regulators that any hoped-for recovery may be derailed before it really gets started.

Some $83 billion in office, retail, industrial and apartment properties have fallen into default, foreclosure or bankruptcy thus far this year, according to research firm Real Capital Analytics. Some see the commercial default rate hitting 4.1 percent by year's end. Meanwhile, with property values down an estimated 40% from their 2007 peak, most lenders still remain reluctant to foreclose on devalued properties in such a deadly market.

Commercial real estate now accounts for 13% of the Gross Domestic Product and plays an integral role in the U.S. economy. It is a linchpin in the nation's financial system.

Key Concerns:

• Private commercial construction will continue to contract sharply, impacting GDP growth.

• Nearly $1 trillion in short-term commercial mortgages are slated to mature by the end of 2010.

• Lenders' losses may total $250-500 billion, especially hurting regional and local banks.

• Banks' commercial real estate losses will keep them cautious on lending through 2010.

All this is happening at the same time that residential mortgage foreclosures are continuing to rise sharply, triggered by the nation's high unemployment rate. Estimates suggest a staggering 1.8 million borrowers will lose their homes this year, up from 1.4 million in 2008.

The Arrival of the Commercial Real Estate Crisis

According to Richard Parkus, a Deutsche Bank analyst who wrote a commercial real estate report in late April 2009, an estimated $1.3 trillion in loans to commercial property owners will be coming due between now and 2013. Parkus estimated that at least half the loans—and two-thirds of those loans packaged and resold as securities—will not qualify for refinancing.

"People are only now beginning to realize there is a looming crisis," he said.

The Achilles' heel of commercial real estate is vacancy rates. Not surprisingly, vacancies nationwide are up and expected to reach 13.5% for retail and 17% for office buildings. This, in turn, decreases the potential income that commercial properties need in order to make mortgage payments.

"I doubt too many banks will want to own a lot of commercial properties that are empty," comments George Raitu, an economist for the National Association of Realtors.

The current extraordinary weakness in the U.S. commercial real estate market is poised to plunge the economy under water for a very long time.

Some 9 million jobs are generated or supported by real estate. These jobs touch all areas of the economy and are in construction, planning, architecture, environmental consultation and remediation, engineering, building, maintenance and security, management, leasing, brokerage, investment and mortgage lending, accounting and legal services, interior design, landscaping, cleaning services and more.

The repercussions go further than the workforce, however. The implosion of the commercial real estate market could significantly reduce the value of Americans' pension funds invested in commercial real estate equity. Construction, hotel and retail workers will lose jobs. Moreover, state and local governments will confront the prospect of reduced tax revenue and the loss of recording and transaction fees.

In testimony before Congress in early July, Jeffrey Deboer, CEO of the Real Estate Roundtable, said: "The current credit system in America simply does not have the capacity to meet the legitimate demand for commercial real estate debt. As demands for debt remain unmet, stress to the financial services system overall, individual financial institutions, and those who have invested in real estate directly or indirectly will increase." Assessing the situation, he added, "This is a market failure of catastrophic proportions."

The Crisis is Pervasive

These are the dimensions of the potential crisis:

• The number of transactions is down 80%.

• Asset values are estimated to have fallen an average of 35% from their peak.

• Capitalization rates have climbed 250 basis points while rents have declined up to 20% depending on property type.

• With so few transactions, there is no effective price discovery.

• Without sufficient price discovery, it is almost impossible to determine loan-to-value, the linchpin metric in lending.

Federal Reserve Chairman Ben Bernanke told Congress in July that he is encouraging banks to work out troubled real estate loans. Yet Bernanke believes that anything more substantial in the form of intervention would require Congress to decide. "I think, really, Congress has to make those trade-offs between the fiscal cost, the fiscal risk and …a very real risk on the side of foreclosures and the problems in commercial real estate," he said.

Averting a Crash Landing

What can be done to avert a second economic disaster?

Deboer of the Real Estate Roundtable recommended to Congress that the following federal policy actions be enacted as soon as possible:

1. Extend the Term Asset-Backed Securities Loan Facility (TALF) beyond its current December 31, 2009 sunset date, through the end of 2010.

2. Establish a federally backed credit facility, possibly created from the PPIP structure or a privately-funded guarantee program for originating new commercial real estate loans.

3. Encourage foreign capital investment in U.S. real estate by amending or repealing the outdated Foreign Investment in Real Property Tax Act (FIRPTA).

4. Encourage banks and loan servicers to extend performing loans, based on cash flow analysis; and temporarily amend real estate mortgage investment conduit (REMIC) regulations to facilitate early review and possible modifications to the terms of commercial mortgage loans that have been securitized in CMBS.

5. Reject new anti-real estate investment taxes, such as the carried interest proposal, and provide a five-year carry-back for the net operating losses of all businesses.

Implications For Business

• Understand your immediate commercial real estate situation. What is the financial health of your landlord? What is the vacancy rate in your building? Are building services being cut back to save money? How is all this affecting your own business, its brand, its image?

• With the possible collapse of the commercial real estate market, unemployment will persist in all job sectors.

• Be prepared for an increase in crime as unemployment benefits end for America's jobless.

• The financial future of companies with large real estate holdings will be suspect.

• If your building's ownership defaults, how is the lender going to remediate and how does this affect your work environment? What circumstances in your lease allow you to terminate the lease? Will you be forced to move your business to another location? Does this have business interruption insurance implications?

• Each business will need to engage its elected officials at the local, state and federal level on its behalf.

• If a building or neighborhood is in a downward vacancy spiral, is your business taking steps to provide a safe work environment for your employees (e.g., dealing with empty parking lots, too much empty space for security guards to adequately monitor, etc.)?

• Your company's pension committee needs to determine the nature of its investment in commercial real estate securities in both equity and fixed income portfolios. The committee will need to be in close communication with its investment advisers and managers on this question.

Conclusion

The day of reckoning is approaching in the commercial real estate market. The vital question is whether the shoe will drop softly. As we await its landing, it's worth remembering the words of U.S. Airways hero pilot of Flight 1549, Captain Chesley "Sully" Sullenberger, moments before landing in the Hudson River, "Brace for impact."

The commercial real estate market—and, therefore, many of us who will be impacted if the economy takes another major hit—need to brace for impact and hope for the best.