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Bad for Business

Commercial Real Estate Faces Uphill Climb

By Gerald Klassen
and Mark G. Dotzour

So far, the crisis in commercial real estate (CRE) has looked more like a slow-motion train wreck than the massive explosion felt when residential mortgage-backed securities (RMBS) failed. Vulture investors are raising cash to take advantage of a flood of distressed properties that *should* be coming on the market.

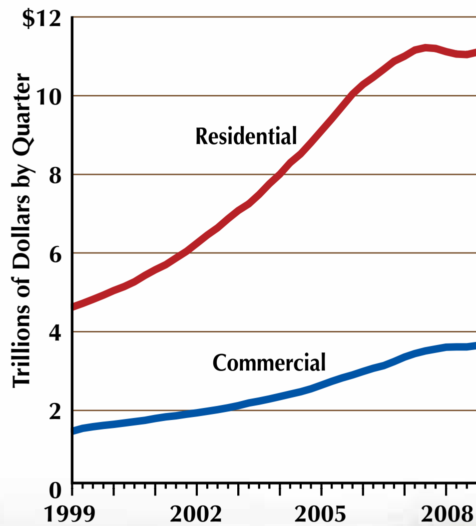
But was the RMBS crisis really that sudden? And did we learn something from the RMBS crisis that will impact the way the CRE crisis unfolds? Will fixing the commercial mortgage-backed security (CMBS) market really prevent a crash? How will the size of the commercial real estate crisis compare with the residential crisis (Figure 1)?

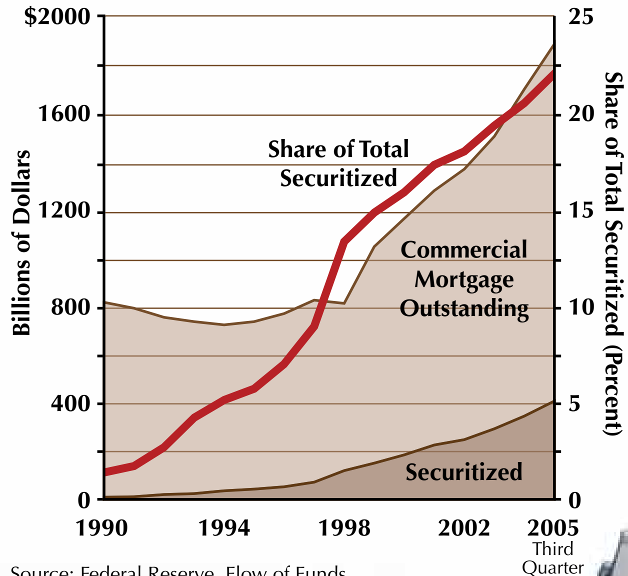
This article draws on past market events to project how the CRE crisis might unfold.

Establishing Timeline

The credit crisis created by RMBS did not suddenly materialize in the fall of 2008. It took nearly two years to evolve. The crisis in the banking system started in February 2007 when Hongkong and Shanghai Banking Corporation (HSBC) announced a $10.5 billion loss on subprime mortgages. Then, in spring 2007, hundreds of mortgage lenders entered into bankruptcy. In June 2007, Bear Stearns announced it had spent $3.2 billion bailing out two of its funds exposed to the subprime market. It was not until March 2008 that Bear Stearns finally failed and was sold to J.P. Morgan.

The crisis reached a crescendo in the fall of 2008 when Lehman Brothers and AIG failed and the Troubled Asset Relief Program (TARP) was born. Given that commercial mortgages have only begun to enter special servicing on a larger scale and the number of CRE-related failures is few, the CRE crisis is likely still in its early stages.





Financial Crisis

The CRE crisis is both financial and fundamental. The financial crisis is being fueled by a lack of available debt financing because of damaged bank balance sheets and failure of the securitization market. Based on media reports, one might believe that CRE is in crisis because of the collapse of the CMBS market. The most public efforts to save CRE so far have centered on reviving the CMBS market. While it is true that CMBS played a significant role in CRE growth between 2004 and 2007 (Figures 2 and 3) and the seizure of the CMBS market has been dramatic, the damage to bank balance sheets has had a more dramatic effect on the crisis.

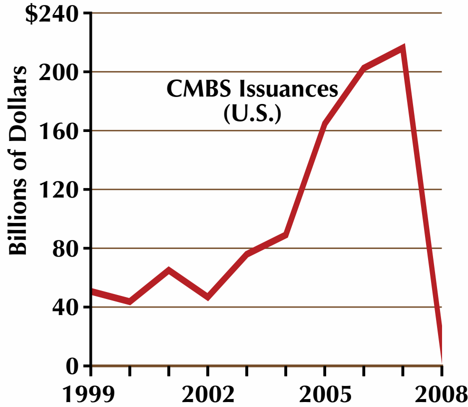
Total CRE debt outstanding is over $3 trillion. Approximately $1.46 trillion is held by banks on their balance sheets (Figure 4). Approximately $1.1 trillion is held in publicly traded securities like CMBS, government agency paper and mortgage real estate investment trusts (REITs). Even if efforts like the Term Asset-Backed Securities Loan Facility (TALF) or the Legacy Securities Public Private Investment Program (PPIP) have a positive impact on securitization, debt capital for CRE is likely to remain severely constrained until bank balance sheets are repaired. In the current credit environment it is doubtful that the CMBS market can be ramped up fast enough to significantly replace the coming wave of loan maturities.

An estimated $300 billion to $600 billion of commercial mortgages will mature by the end of 2009. These loans are held by a variety of sources. Over the next few years the amount of maturing loans will increase (Figure 5). The majority of this debt is in whole loans that are not held in CMBS pools. This means that banks will be under heavy pressure to roll or extend these loans. Given their damaged balance sheets, it is hard to imagine how banks will be able to keep up with the demand for new commercial mortgages.

Fundamental Crisis

The fundamental crisis in CRE is being driven by changing consumption levels and is reflected in corporate earnings reports. Consumers are spending less and saving more. When they do shop, they look for lower-cost goods and services. The results are being felt in corporate earnings.

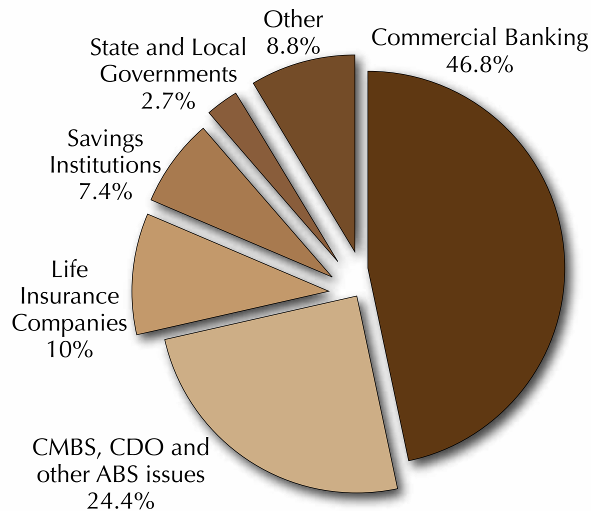
Figure 3. Growth and Collapse of CMBS Market



Sources: Commercial Mortgage Alert; Commercial Mortgage Securities Association (courtesy of Real Estate Roundtable)

Figure 4. Commercial Real Estate Debt Capital Sources

Approximately $3.1 Trillion in Loans Outstanding



Source: Mortgage Bankers Association (courtesy of Real Estate Roundtable)

The dominant trend in 2009 has been for firms to exceed profit expectations but miss on revenue estimates. Revenues are falling because businesses have to discount prices to make sales (deflation).

Profits are exceeding expectations because firms are managing their costs better. That means they are cutting employees, reducing real estate holdings and negotiating lower rent levels with landlords. This has had a direct negative impact on net operating income for commercial real estate. So while the stock market rose this spring on the back of good news about corporate profits, it came largely at the expense of jobs and CRE.

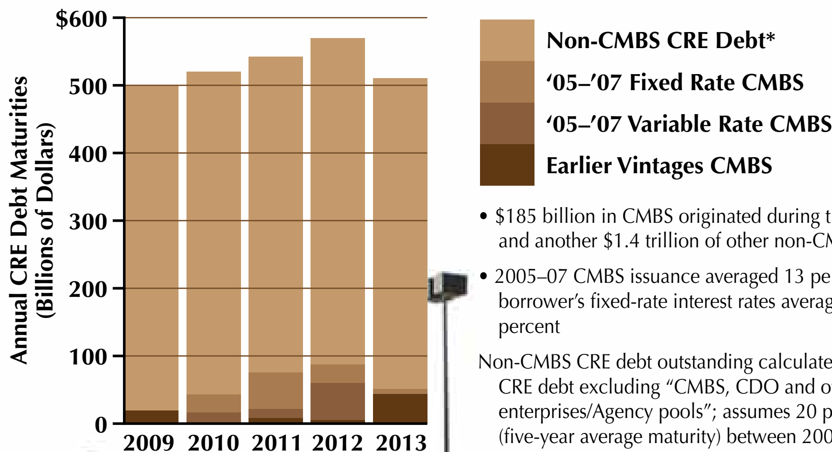
The reality is that the long-run demand for commercial space may not be as much as was thought at the height of the boom. The historic level of economic activity that drove demand for new products and businesses was fueled by an unsustainable level of consumption. Consumers were not only spending their savings but they were also borrowing against assets to drive their consumption even higher. From 2004 to 2007, consumers were extracting between $600 billion and $700 billion of equity per year from their homes (Figure 6). This money provided significant economic stimulus that created new demand for all forms of CRE.

A correction in long-term consumption patterns to a more sustainable level is now underway. It is possible that the personal savings rate could rise to seven or eight percent, a level not seen since the late 1980s and early 1990s (Figure 7). If this happens, there could be prolonged sluggishness in CRE until the economy grows enough to absorb the current excess capacity.

Congress not coincidentally adopted a fiscal stimulus package of $787 billion in a valiant attempt to replace lost consumption. But to maintain the economic status quo, Congress likely will need to continue passing stimulus packages. And doing so could cause the national debt to balloon and do long-term damage to the economy.

The unwillingness of lenders to renew existing mortgages reflects uncertainty about market fundamentals. It also reveals the disconnect between prior appraisals and the new economic reality. Outsized rent growth projections during the boom years are being replaced by deflating lease rates and growth in vacancy. Until the savings rate reaches its new equilibrium and

Figure 5. Coming Wave of CRE Debt Maturities (CMBS and Non-CMBS debt)*



Non-CMBS CRE Debt*

'05–'07 Fixed Rate CMBS

'05–'07 Variable Rate CMBS

Earlier Vintages CMBS

- $185 billion in CMBS originated during the peak vintage years (2005–07) and another $1.4 trillion of other non-CMBS CRE debt* matures 2010–12
- 2005–07 CMBS issuance averaged 13 percent AAA subordination levels; borrower's fixed-rate interest rates averaged between 5.5 percent and 6.2 percent

Non-CMBS CRE debt outstanding calculated as portion of total outstanding CRE debt excluding "CMBS, CDO and other ABS issuance" and "GSE enterprises/Agency pools"; assumes 20 percent matures each year (five-year average maturity) between 2009 and 2014.

Sources: Green Street Advisors; Mortgage Bankers Association; Wells Fargo; Trepp; Bank of America (courtesy of Real Estate Roundtable)

consumption stabilizes, it will be difficult to ascertain the correct set of assumptions for valuing CRE.

Opposing Forces

When will foreclosures finally produce the wave of distressed commercial properties that investors are preparing to purchase? It is difficult to know because opposing forces are at work to produce or prevent foreclosures. The key will be to monitor trends in the opposing forces.

The number of foreclosures on commercial properties will contribute to the final wave when they reach a critical mass. When enough foreclosures occur, the stream of distressed sales will follow. This will produce enough comparables that bankers and investors will have no choice but to change their opinion about investment values. It is difficult to know where that point of critical mass is.

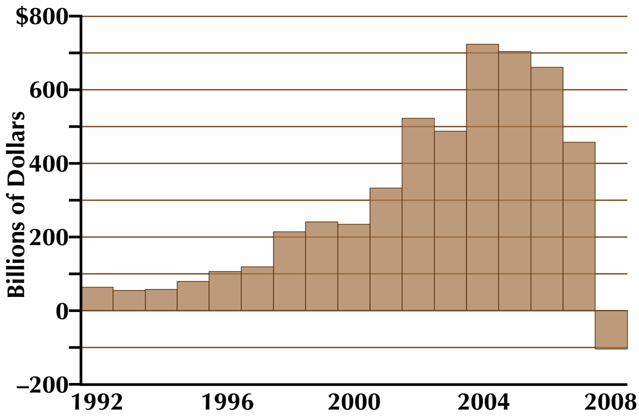
The largest source of foreclosures will come from banks. Richard Parkus of Deutsche Bank, testifying before the Joint Economic Committee of Congress on July 9, 2009, said, "The view that core commercial real estate loans in bank portfolios are likely to underperform those in CMBS is supported by the fact that delinquency rates for bank loans have for many years far exceeded those of CMBS loans. As of the end of the first quarter of 2009, the delinquency rate on bank CRE loans was approximately 2.5 times that on fixed rate CMBS loans."

Lessons learned during the RMBS crisis will motivate banks to postpone commercial property foreclosures. Banks are still smarting from the surge in asset write-downs they performed in the RMBS crisis. Given their fragile financial state and memories of the damage created by transparency, banks will find every way possible to reasonably justify delaying foreclosures on commercial property. When they have rebuilt their equity capital and overcome the devastating RMBS losses, banks may be more inclined to speed the pace of commercial foreclosures.

When the personal savings rate and consumption stabilize, the economy will stabilize and reduce the pressure for foreclosure. As long as the savings rate increases, economic activity will fall and reduce the demand for CRE.

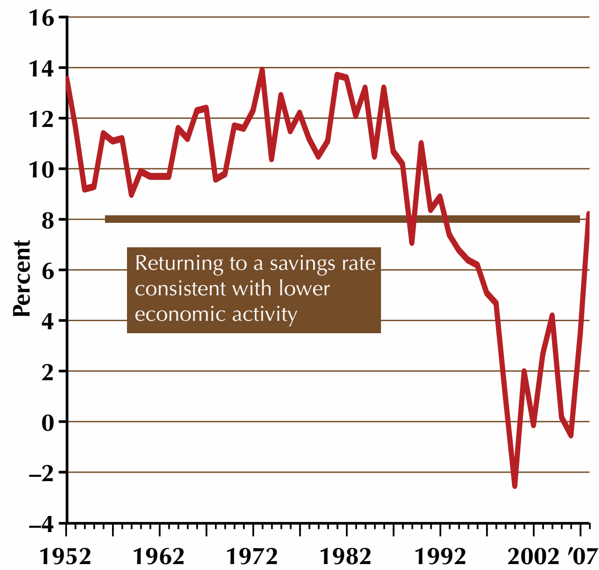
Historical cost accounting for whole loans works against foreclosure if institutions use a liberal approach to classifying "distressed" whole loans. Recent modifications in accounting rules also work against foreclosure. The suspension of mark-to-market accounting makes it possible for bankers to be more liberal in the way they value securities. They can postpone realizing losses on assets that are performing at a minimum level but are, in reality, worth less than the value of the loans. If banks are permitted to carry assets at inflated values or "extend and pretend" on maturing loans, the rate of foreclosures and distressed sales will mirror the rate of upcoming mortgage maturities.

Figure 6. Economic Stimulus and Net Home Equity Extraction



Source: "Estimates of Home Mortgage Originations, Repayments, and Debt On One-to-Four-Family Residences," Alan Greenspan and James Kennedy, Federal Reserve Board. FEDS working paper No. 2005-41. Updated estimates of the mortgage system provided by James Kennedy. Updated report: "Sources and Uses of Equity Extracted from Homes," Alan Greenspan and James Kennedy, Federal Reserve Board FEDS working paper 2007–20 (October 2008).

Figure 7. Historical Personal Savings Rate



Source: Bureau of Economic Analysis

The FDIC's current staffing level makes it difficult for them to force banks to foreclose on commercial real estate if doing so would place the bank in jeopardy. The FDIC could not achieve an orderly unwind of banks if too many failed simultaneously.

In December 2008, the FDIC approved an 80 percent increase in their operating budget to $2.4 billion for 2009. They also approved a 30 percent increase in staffing that will fund 1,459 new examiners and manage the sale of assets retained by the FDIC when a failed bank is sold.

Surge in CRE Foreclosures Uncertain

Compared with the crisis in residential real estate, the crisis in commercial real estate is still relatively new. It took 20 months for the residential crisis to reach its climax. Since that time, the Federal Reserve Bank, U.S. Treasury and FDIC have implemented many programs to prevent a similar crisis. Financial markets have calmed and accounting rules have been changed so the likelihood of another severe crisis is less likely.

At present it seems that the forces working against a surge in CRE foreclosures are stronger, but that does not mean CRE foreclosures will not eventually rise. The key to preventing a severe crisis will be to either repair bank balance sheets or develop a meaningfully large CMBS market.

In the absence of these actions, the risk of a large wave of foreclosures in the next year rises significantly. If the forces opposing foreclosure remain in place, the trend in foreclosures will likely mirror the wave of commercial mortgage maturities and stretch out over the next four years.

Regardless of the foreclosure crisis, CRE faces significant headwinds as the economy resets to a new normal. The rising personal savings rate and lower level of consumption will put downward pressure on economic activity. This will dampen demand for commercial real estate for the next four years and produce a restrained recovery in the subsequent years.

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THE TAKEAWAY

Commercial real estate (CRE) will not have as large an impact on the financial system as the residential mortgage crisis, but the next four years will bring rising commercial foreclosures. An increase in the personal savings rate will dampen demand for CRE. To avert a severe crisis, bank balance sheets must be repaired or the commercial mortgage-backed securities market must be restored.

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