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Commercialspeak

TAR Panel Insights

By Harold D. Hunt

Commercial real estate is often mentioned as "the next shoe to drop" in any discussion of looming barriers to economic recovery. Although the Texas economy is displaying more signs of life than most other states, the apprehension over future commercial market performance is still palpable.

The Texas Association of Realtors (TAR) chose to address this concern by holding the 1st Annual Texas Commercial Forum during their annual convention in Galveston. The TAR commercial committee, a coalition of Texas Realtors practicing in the commercial arena and advocating for improvements in the industry's business climate, included a panel discussion as part of their regular meeting.

Five panelists from a variety of sectors tied to commercial real estate were asked their opinions about issues affecting the state's commercial real estate markets. Highlights of a question and answer period follow.

Why the lack of good deals for commercial real estate buyers?

Wilson: Banks are only taking back the worst of the worst properties. And they are only choosing foreclosure as an absolute last resort. Strong borrowers are being told to move their loans or decrease their principal or their interest rate will be increased. Weaker borrowers have no money. Lenders are trying to kick their loans down the road by making them interest-only. The worst borrowers are not engaged at all. Banks don't want their properties, so they are selling these notes to nonbanks at a discount.

O'Connor: Banks are attempting workouts when possible. The FDIC has strongly encouraged banks to work with borrowers. This environment should change very little during the next year or two. The FDIC simply doesn't have the money to shut down all the insolvent banks.

The plan is to continue extending problem loans, provided borrowers are honest, capable and attempting to do their part. The hope is that borrowers will be able to pay off the loans in three to five years as the economy improves. Banks will use their operating profits to gradually take loan losses over a period of years. So there will be no flood of bank foreclosures on commercial properties.

Wall Street lenders, aka commercial mortgage-backed securities (CMBS) lenders or conduit lenders, will be selling both loans and foreclosed assets. They are being much more aggressive in addressing problem loans compared with banks. Although they are ready to accept the problems and resolve them, CMBS lenders have found themselves short-staffed and overwhelmed.

Holshouser: We are seeing a slow trickle of distressed real estate owned (REO) assets coming to market. This is up from none 12 months ago. We think most REO opportunities will come from CMBS lenders in the near term. Long-term, banks will probably deliver foreclosures to the market. But that remains much further off.

McCrocklin: Buyers are looking for steals. Sellers are looking to maximize their disposition price. In many cases, sellers are like lenders. They don't want to, or can't afford to, recognize a loss. So the market isn't clearing.

In the 1980s, we had "neutron properties" that destroyed the owner, the lender, or both, and left the property intact. Today we have zombie banks with zombie loans that are dead but being kept alive by financial institutions.

Without some type of mark-to-market or real-time value of asset-collateral values, the commercial real estate market will not find a floor. Without a floor, our recovery could look a lot like Japan's, extending out ten to 15 years or more.

Reyna: If there is a Class-A product for sale in Texas, you will see multiple bidders. But outside the Class-A properties, it is hard to say that the commercial real estate market has hit bottom yet. We need the Resolution Trust Corporation back.

We are also hearing concerns about potential capital gains increases. Some sellers are actually hedging this by saying if capital gains increase, the sales price also increases by 7 percent.

What about the availability of financing for commercial property?

O'Connor: The good news is commercial real estate financing has increased. However, in the banking sector, regulators are acting like real estate is toxic. The most difficult assets to finance are hotels, land and any nonperforming real estate.

Based on my conversations with local mortgage bankers, perhaps 90 percent of local banks are not actively lending on commercial real estate. In general, national banks are more likely to lend on commercial real estate than regional banks, and regional banks are more likely than community banks.

The banks would like to lend, but based on the 300 percent rule the regulators have told them not to. Commercial real estate lending is limited to 300 percent of a bank's risk-based capital. The rule started as a simple guideline in 2007. It is now being treated as a hard and fast rule.

Nonrecourse financing is being offered by life insurance companies but not by banks. Conduits have begun to increase their lending activity as well. Banks and life insurance companies are both requiring a significant equity contribution.

Conduit loans will be the most significant source of distressed commercial real estate sales in the next year or two. If you are looking for distressed assets, look to the CMBS special servicers.

Holshouser: Some construction lending is being carried out by commercial banks on office and multifamily properties. Commercial banks are dominating owner-user building financing today. Permanent lending by commercial banks on any property type for nonuser properties is virtually nonexistent.

Fannie Mae and Freddie Mac are financing stabilized multifamily properties at 80 percent loan-to-acquisition price and 75 percent loan-to-refinancing value. FHA and HUD loans have been popular, but they tightened their standards in September 2010. They increased their debt service coverage ratio on the popular 221(d)4 program from 1.11 to 1.2 and decreased their loan-to-value (LTV) ratio from 90 percent to 83 percent.

Life insurance companies are primarily making loans on stabilized properties. They are using a 65 to 75 percent LTV ratio for loans sized to $1 million or higher. These are usually nonrecourse loans offering 20- to 25-year amortization periods.

Strong borrowers can generally get financing for deals of $15 million or more through CMBS nonrecourse loans offering a 70 percent LTV ratio.

What about the ability to estimate the value of distressed assets?

O'Connor: The market is opaque due to lack of transactions. Banks are working more closely with brokers than appraisers in setting the values of distressed real estate. The issue is not understanding what values are. The issue is being willing and able to take the write-downs.

McCrocklin: A lack of comparable sales is causing appraisers to apply heavy discount rates, resulting in lower values. There is also a huge shadow market out there that will have a negative impact on values at some point.

Commercial Forum Panelists

Reid Wilson, attorney, Wilson, Cribbs & Goren P.C. and CRE, Houston

Pat O'Connor, MAI and president of O'Connor & Associates, Houston

Will Holshouser, commercial mortgage banker with Trinity Mortgage Finance, San Antonio

John McCrocklin, CCIM and principal at McCrocklin Real Estate, Wimberley

Michael Reyna, CRE, CCIM, SRA and president/CEO of TC Austin Realty Advisors, San Antonio

A. David Schwarz III, SIOR, panel moderator, broker with McDade, Smith, Gould, Johnston, Mason & Co., Houston

The Financial Accounting Standards Board, under pressure from Congress, voted to allow banks and financial institutions "in times of illiquid markets" to reclassify assets from "toxic" to "underperforming" or "exceptional" assets. This suspension of FAS-157 Fair Value Measurement (mark-to-market accounting) has hidden bank losses and is preventing recovery of the real estate markets.

Any final thoughts?

McCrocklin: The United States is going to switch from generally accepted accounting principles to International Finance Reporting System (IFRS) as of Dec. 15, 2014. IFRS has already adopted FAS-157 Fair Value Measurement, so mark-to-market accounting will return to our commercial real estate markets by late 2014 whether we like it or not.

Suspension of FAS-157 has prevented the real estate market from finding a floor for recovery. It has lowered asset values, lowered investor confidence and has kept investors on the sidelines.

One solution would be for banks to mark all their assets to market over a five-year period with a recognition of 20 percent of the assets each year, starting with the worst assets. The result would be similar to what we encountered in Texas and the Southwest during the 1980s when 19 percent of all loans were not performing.

Texas recovered then because the collateral was marked-to-market, and the losses were recognized. As a result, investors regained confidence that the market had bottomed and the market responded by readjusting upward.

Recognizing the losses on a phased-in basis would have the same result today. It would improve the value of the remaining loan portfolios. This would mitigate further losses in the future as they become recognized over the five-year period. We can't afford to sit and "pray and delay" that the market will recover without a floor.

Wilson: With regard to foreclosure, judges are giving some borrowers one free pass and then no mercy. After foreclosure, deficiency judgments apply personal liability for the difference. Many nonrecourse loans have a "springing guarantee" that makes them full recourse. These are being upheld in court. Remember that most actions can delay foreclosure, but they typically don't stop it.

Holshouser: Texas is one of the best states for commercial real estate today. We have a better economy and more lender-friendly foreclosure laws than most other states. Lenders have come to recognize Texas as a fundamentally superior commercial real estate market during this phase of the economic cycle.

O'Connor: We need the government to do two things: set the rules and get out of the way. Due to the level of uncertainty, businesses have become unwilling to make decisions and risk capital. Just give us a clear and reasonable set of rules.

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THE TAKEAWAY

A panel of commercial real estate professionals expressed frustration with the paucity of transactions. Suggestions for jump-starting the stalled market include reviving the Resolution Trust Corporation, creating a system of real-time valuations, and encouraging the government to set the rules and get out of the way.

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