



THE COMMERCIAL TSUNAMI BY NATHAN MOEDER

While the residential market is showing signs that it is hitting bottom, it is now evident that the next wave of real estate distress is forming in the commercial sector.

In January 2008 there were 459 loans either delinquent or in some state of foreclosure throughout the U.S. according to data released from Deutsche Bank. Of the total CMBS market (69,326 loans) this represented only a 0.38% delinquency rate. Fast forward to March 2009 and the number of delinquent loans has increased to 1,483, or 1.81%, now matching the peak of the last recession (November 2003).

Underwriting

What has transpired to cause such a dramatic turn for the worse in the commercial markets? It's part of the residual impact of negative economic factors such as job loss, vacancies and decreasing rents.

But this is not the problem going forward. From 2005 to 2007 credit was flowing. There was high demand for CMBS paper, much like residential subprime, and credit spreads that influence interest rates were minimal. This time period experienced low interest rates, higher LTVs, and low debt coverage ratios. In addition, a significant number of commercial loans in this period were interest only.

The financing world has now changed and it will take time for banks to stabilize and credit markets to price these emerging risk assets. Until then, underwriting standards will remain tight. According to our research and Deutsche Bank, credit spreads are 500 basis points (driving up interest rates) and lenders are requiring more equity and higher debt coverage ratios. This will significantly impact commercial values, which we estimate to decrease in the range of 34% to 43% (see underwriting table). Even if we assume some improvement in underwriting (70% LTV, 250 credit spreads, 1.25 DCR), the devaluation is still 32% because revenue projections are now lower.

Time's Up: Maturity Default

The new conundrum relates to loans that are coming due. Many loans will not qualify for refinancing under current underwriting standards. According to Deutsche Bank, 14,459 loans will mature during the 2009 – 2012 period. Assuming loan-to-values under 70%, approximately 7,400 loans (51%) will not qualify for refinancing. If underwriting standards are more lenient and include LTVs up to 80%, still 6,000 loans will not qualify (42%).

In 2008 over 400 loans per month were being paid off or refinanced. In 2009 the number has dropped to less than 100 per month. In addition, the number of loans passing the maturity date without refinancing has increased from 50 per month in January 2008 to 200 in January 2009.

Loans that do qualify are not without risk either. Players in the capital markets are now sidelined and are not willing participants to buy paper. But without this capital market lifeline, it's difficult to generate enough funds to refinance all the loans.

One outcome could be a good 'ol standoff where the owner offers the keys, but the bank refuses because they would have to find someone to operate the asset or sell it at a steep discount to a bargain hunter. So the bank waits until the property can refinance.



However, a mass extension of loans anticipating quick economic stabilization or even value appreciation is a dicey bet in this economy. Even when the economy does stabilize, it will take some time to generate jobs and fill those empty spaces. This suggests that some devaluation is imminent and such transactions will continue to drag down the prices of all commercial properties. At some point, banks will be forced to act.

In order to avoid what is upon us, here's what it would take:

- 1) Job creation to occupy space;
- 2) A "fixed" banking system that now lends money to businesses to expand, hire and purchase;
- 3) Returned confidence in the credit markets to bring down rates and loosen underwriting.

In other words, we need a full economic recovery.

Unfortunately – or fortunately, if you're an opportunist – this could last for a couple years while we work through the CMBS market and towards economic recovery. For those holding cash, get it ready, there is a wave to ride.

Commercial Real Estate Underwriting
Suggests 34% to 43% Decline In Valuation

	2007 Underwriting	New Underwriting	Future Underwriting 15% NOI Decline	Improved Underwriting 15% NOI Decline
Valuation Decrease		(34%)	(43%)	(32%)
Purchase Price	\$100,000,000	\$66,500,000	\$56,607,589	\$67,643,936
NOI	\$4,802,500.00	\$4,802,500.00	\$4,082,125.00	\$4,082,125.00
Acquisition Cap Rate	4.80%	7.22%	7.21%	6.03%
LTV	85%	65%	60%	70%
Loan Amount	\$85,000,000	\$43,225,000	\$33,964,553	\$47,350,755
Equity	\$15,000,000	\$23,275,000	\$22,643,036	\$20,293,181
Amortization	Interest Only	30 YR	30 YR	30 YR
10 YR Treasury	4.70%	2.86%	2.86%	2.86%
Swap Spread	50	25	25	25
Credit Spread	45	500	500	250
Total Interest Rate	5.65%	8.11%	8.11%	5.61%
Debt Service	\$4,802,500	\$3,845,887	\$3,021,951	\$3,265,553
DCR	1.00 x	1.25 x	1.35 x	1.25 x
YR 10 NOI	\$6,500,000	\$6,500,000	\$5,500,000	\$5,500,000
Disposition Cap Rate	5.00%	7.22%	7.21%	6.03%
YR 10 Value	\$130,000,000	\$90,005,206	\$76,269,526	\$91,139,210
Equity IRR	13%	13%	12%	14%

Source: The London Group Realty Advisors, Deutsche Bank