

THE COMING WAVE OF COMMERCIAL REAL ESTATE MORTGAGE DEFAULTS

BY WALLACE G. MURFIT

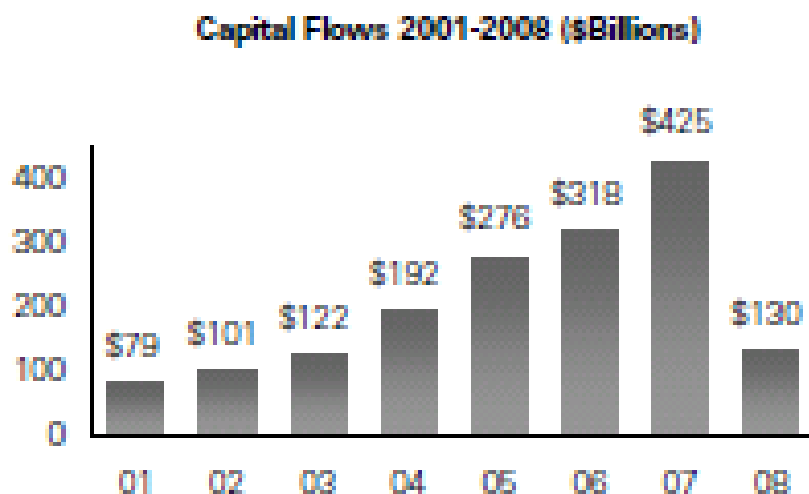
The next five years will bring unprecedented challenges for U.S. commercial real estate capital markets ... and unprecedented opportunities. The vast amount of mortgage debt which will mature between 2009 and 2013 cannot be refinanced in the current prevailing market, and so there will be a colossal refinancing shortfall . This de-leveraging of U.S. real estate will create a challenge for lenders and borrowers and an opportunity for astute investors with fresh capital.

This article will describe (A) the size and nature of the U.S. commercial real estate mortgage market, (B) the impact of the 2003-2007 mortgage market (C) the effects of a refinancing shortfall, (D) what are the new investment opportunities, and (E) how those opportunities will be found.

A. The U.S. Commercial Real Estate Mortgage Market

The value of all commercial real estate in the U.S. is approximately \$6.5 trillion, of which about 50%, or \$3.25 trillion, is debt¹ . During the five years of 2003-2007, there was a surge in real estate transaction volume, as shown in the following table:

Figure 1

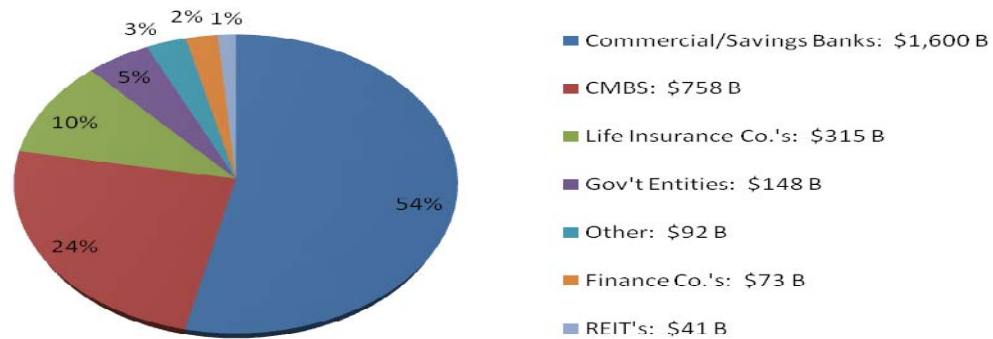


Source: Real Capital Analytics and RREEF Research

This inflow of capital drove prices up and drove yields down. During this five-year period, loan-to-value ratios (LTV) increased over historical ratios, so the amount of lending increased even more steeply than the amount of over-all real estate investment. It can be argued that this investor activity was driven by the availability of credit, or conversely that investor activity created the demand for credit. For whatever reason, the amount of mortgage debt increased precipitously. Between 2000 and 2007, \$1.8 trillion of loans were originated in the U.S.²

It is important to recognize who were the lenders of this capital, because this will suggest where the re-financing shortfall will occur. The following chart shows the make-up of the lenders in the \$3.1 trillion U.S. commercial debt markets. Much has been written about the impending difficulties in the CMBS markets, but as this chart shows, bank debt is more than twice the amount of the CMBS debt.

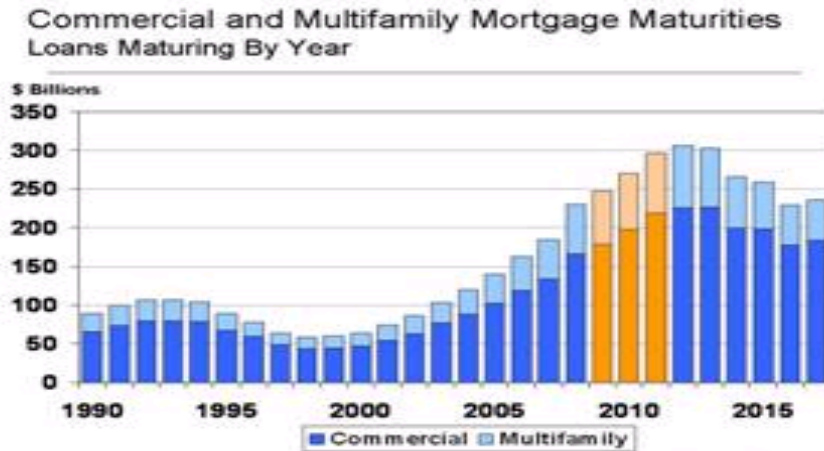
Figure 2



Source: Mortgage Bankers Association/ Eastdil Secured/ Wells Fargo

The terms of these loans were varied, but the majority were written for five to ten years. Following is a schedule of the maturities of U.S. commercial and multi-family mortgages:

Figure 3



Source: Foresight Analytics

This is the most significant chart in this article, because it clearly shows the sheer magnitude of the problem. The debt maturities in the next five years are enormous. According to Foresight Analytics, there will be \$814 billion of loans coming due in 2009-2011. Approximately \$600 billion comes due in 2012-2013, for a total of \$1.4 trillion in the next five years.

There is no obvious source of capital to refinance this debt. As shown in Figure 2 above, 75% of all U.S. commercial mortgage debt is held by banks and/or CMBS lenders. However, the distress of banks has been widely reported, and the CMBS markets have been effectively closed for more than a year. Therefore, neither of these sources will have the capacity to refinance all of this debt.

Certainly some of these loans will be paid off at maturity. Others will simply be extended for a short period, with the hope (by lender and borrower) that the passage of time will enable the property to satisfy the full amount of the debt.

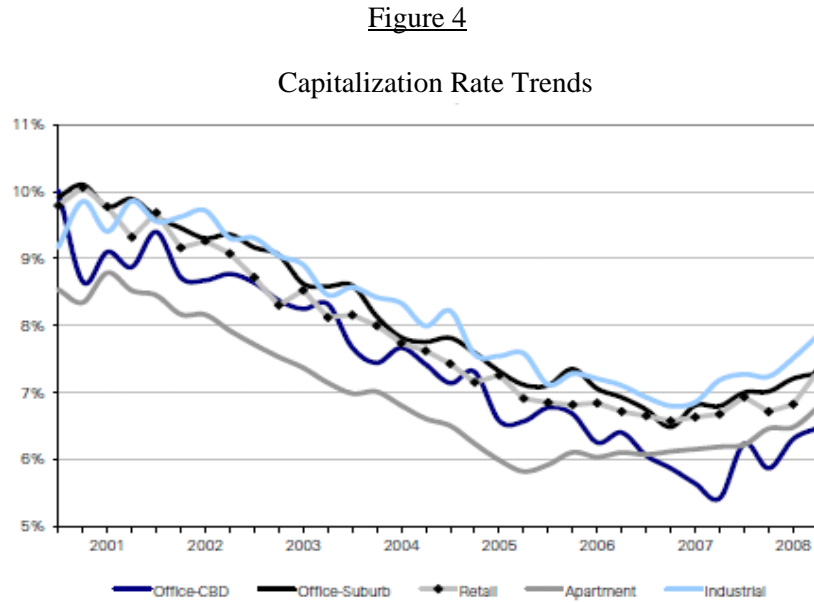
However, there is no question that the vast majority of these loans will suffer a refinancing shortfall at maturity. Moreover, a significant percentage of the underlying properties will be worth less than the amount of the loan at maturity. These are the situations which will offer an opportunity for new capital investment.

B. IMPACT OF THE 2003-2007 MORTGAGE MARKET

A considerable amount of the increase in value of real estate in the years 2004-2007 was due to capitalization rate compression. Increased value and ever-higher loan-to-value (LTV) ratios resulted in extremely high loan amounts per square foot. The potential refinancing of all of these loans will be adversely affected by two diverging trends: a decrease in the value of the property and a decrease in the LTV ratio for the new loan. Deutsche Bank reported that of \$154.5 billion of CMBS which will mature

between 2009 and 2012, approximately two-thirds could not be refinanced in today's market, because their LTV's exceed the current market. Foresight Analytics studied \$524.5 billion of bank loans maturing prior to 2012, and reported that approximately half of them would not qualify for refinancing.

Following is a chart of average cap rates, showing the decline from 2001-2007:



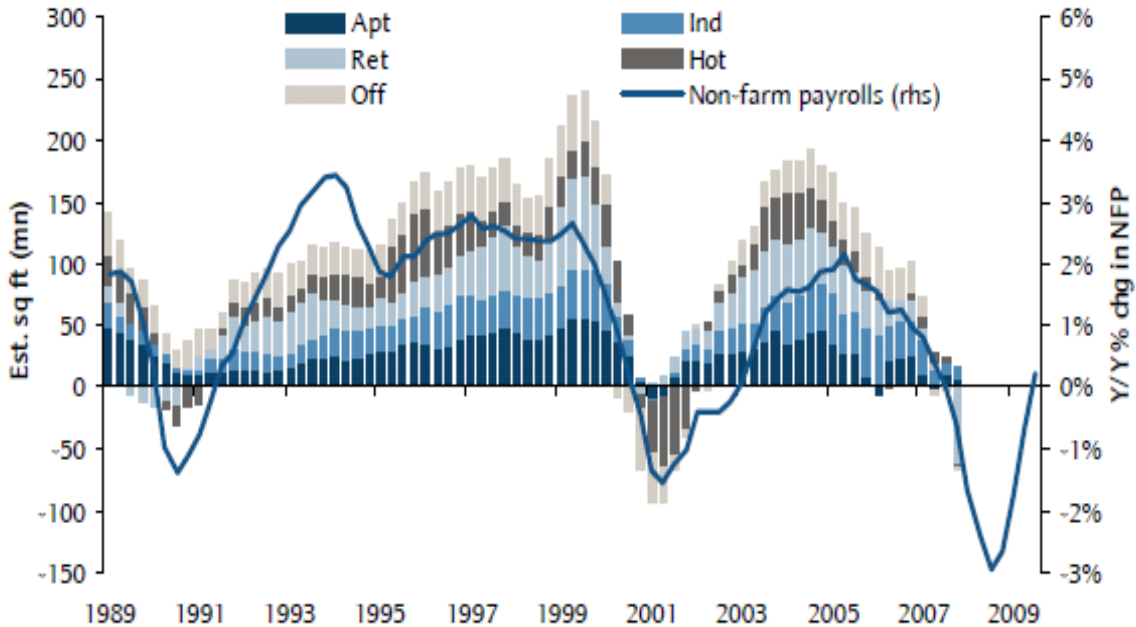
Source: Real Capital Analytics

There are so few transactions which have occurred in the market since mid-2008 that it is difficult to determine precise market cap rates. However, a recent article by RREEF Research found that cap rates had increased 150-200 bps from their prior lows, which resulted in a decrease in value of 20 to 30 percent. Clearly, these cap rates reflect some panic in the market, as well as the relative lack of available credit. We can expect cap rates to rebound somewhat in the future when the market becomes more stable. However, few expect cap rates ever to return to the low levels of 2006-2007.

Moreover, in addition to the loss in value attributable to cap rate increases, most commercial properties will also suffer from a decline in net operating income (NOI) for the next few years. This decline in NOI will be the result of an increase in vacancy and a decrease in effective rental rates. One of the most reliable proxies for commercial real estate is the level of employment in the U.S. Generally speaking, more jobs result in more occupied square footage and vice versa. Unemployment continues to rise, and is predicted to reach 10% by 2010. Wachovia Bank reported a decline of 433,000 financial services jobs in the past 16 months, which will result in approximately 107 million s.f of decreased office occupancy. Not all of the effect of this decline in employment has appeared yet in the vacancy rates, because leases still have remaining term to run. However, there is evidence of the loss of jobs, which is reflected by the surge in sub-lease space coming to the market. Following is a chart showing the correlation between commercial real estate occupancy and non-farm payroll in the U.S. :

Figure 5

Commercial Real Estate Occupancy and Non-farm Payroll



Note: For hotels and apartment, we convert data in units to sq ft by assuming average size/unit is 1,000 and 500 sq ft, respectively. 2009 payroll data are estimated by Barclays Capital Economics. Source: PPR, BLS, Barclays Capital

As this chart shows, there is a very tight correlation between employment (as measured by payroll) and commercial real estate occupancy. Employment is the single most important driver of commercial real estate occupancy. Therefore, real estate markets will only recover when employers add back the jobs which have been lost in the recession. However, when the economy turns around, demand for commercial real estate space will still lag the general economy for two reasons: (1) employers will be slow to re-hire, waiting for the recovery to become more robust (the “jobless recovery”), and (2) employers will still have a certain amount of unused space to grow back into (so-called “shadow space”). The result of these effects will be that real estate values will continue to be depressed for at least five years, through the period of the peak of loan maturities in 2010-2014 described above.

We can see this effect reflected in vacancy rates of all categories of commercial real estate, as shown in the following chart:

Figure 6

U.S. Vacancy Rate Trends

	Actual			Projected		
	2006	2007	2008	2009	2010	2011
Apartment	5.8%	5.7%	6.6%	7.4%	7.0%	5.9%
Industrial	9.7%	9.6%	11.1%	11.8%	11.5%	10.9%
Office	12.7%	12.6%	13.9%	17.8%	18.3%	16.5%
Retail	6.9%	7.3%	9.0%	10.5%	9.5%	8.0%

Source: REIS Reports, CB Richard Ellis/Torto Wheaton, & RREEF Research

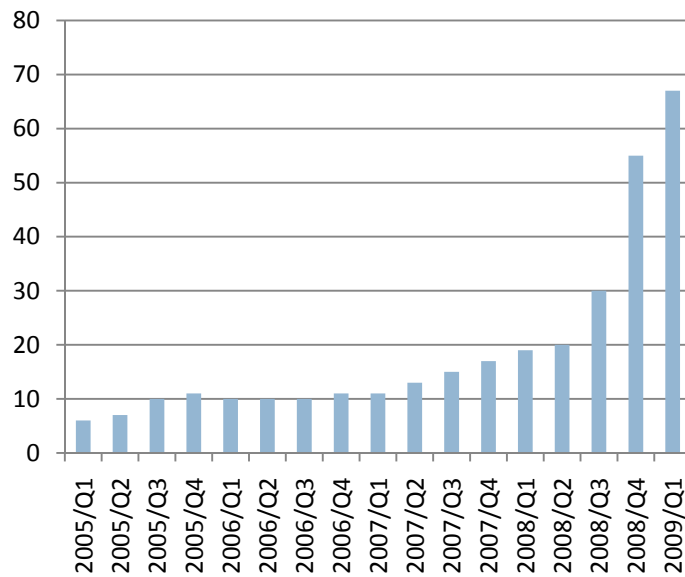
There is evidence that stress is beginning to appear in the market. According to a recent report by Real Capital Analytics (6-4-09), there were \$97.5 billion of distressed and troubled assets in the U.S. at the end of April.

With respect to bank loans, consider the following:

- Of the 8,000 banks and savings institutions insured by the FDIC, two-thirds increased their loan loss reserves in Q1/09, by a total amount of \$60.9 billion³.
- The number of banks on the FDIC's "problem" list increased from 252 to 305 in Q1/09⁴.
- FDIC assets under liquidation rose from \$310 million at 12-31-06 to \$15.3 billion at 12-31-08⁵.
- The FDIC fund that protects bank deposits declined from \$17.3 billion to \$13.0 billion in just the fourth quarter of 2008, as a result of bank failures. The FDIC has decided to assess a special fee of \$5.6 billion to replenish the fund⁶.
- The FDIC had seized 34 banks in 2009 as of May 31⁷.
- The Federal Reserve required the 19 largest banks to perform "stress-tests", from which the Fed concluded that 10 of those banks needed to increase their capital. The Wall Street Journal did a study of 940 small and mid-sized banks (11.8% of the FDIC-insured banks), applying the same "stress-tests". The Journal concluded that potential losses from commercial mortgages could exceed \$100 billion at those banks by the end of 2010⁸.
- Moody's reported in June 2009 that their rated banks face losses of \$470 million through 2010.
- Following is a chart which shows the increase in bank loans past due:

Figure 7

Bank Real Estate Loans 90 Days or More Past Due (\$ Billions)



Source: FDIC, Wall Street Journal

The CMBS market shows similar signs of impending distress:

- In the first quarter of 2009, the amount of loans rated by Fitch which were transferred to special servicing increased 48% to \$23.7 billion. The amount in special servicing at 12-31-07 was \$4.8 billion; this represents an increase of 494% in fifteen months. Fitch expressed concern about the ability of the special servicers to cope with the increase in loan volume in the future.
- S&P reported that 45% of all CMBS loans which came due in Q1/09 were not paid off.
- The delinquency rate on all CMBS loans has more than doubled since Q3/08 to 1.8%⁹.
- A recent study by Deutsche Bank predicts that, of \$154.5 billion of CMBS loans maturing between now and 2012, two-thirds will not qualify for refinancing.
- Two-thirds of the CMBS loans placed in special servicing were originated in the big run-up years of 2005-2007, where LTV's were the highest¹⁰.

Despite these statistics, foreclosures in commercial mortgages have been remarkably low. However, a few landmark deals have been reported:

- In March 2009, Normandy Real Estate Partners and Five Mile Capital Partners bought the 1.7 million s.f. Hancock Building in Boston, assuming the first mortgage of \$640 million when Broadway Partners defaulted¹¹.

- In June 2009, AIG sold its 1.4 million s.f. New York headquarters building to a Korean investor for less than \$100 p.s.f.
- In June 2009, Cronheim Mortgage purchased a \$103.5 million mortgage from Key Bank at an undisclosed discount, secured by three office buildings totalling 1.2 million s.f.¹³.
- In June 2009, Maguire Properties reported that it had defaulted on a \$106 million CMBS loan on a 566,000 s.f. office building and was in discussions with its special servicer¹⁴.
- Here in the Bay Area, in June 2009, CIGNA foreclosed on a 455,000 s.f. office complex in San Rafael, when Hines defaulted on the \$62.3 million loan¹⁵.
- In San Francisco, Realty Finance Corporation is marketing a \$43 million loan on 250 Montgomery Street, owned by Lincoln Property Co. It has been reported that the loan is expected to trade at approximately \$200 p.s.f., half of what Lincoln paid for the building in December 2006¹⁶.

Notwithstanding these transactions, most experts are surprised that there have not been considerably more collapses. There are several structural reasons why banks and CMBS lenders have refrained from foreclosure to date, granting loan extensions instead.

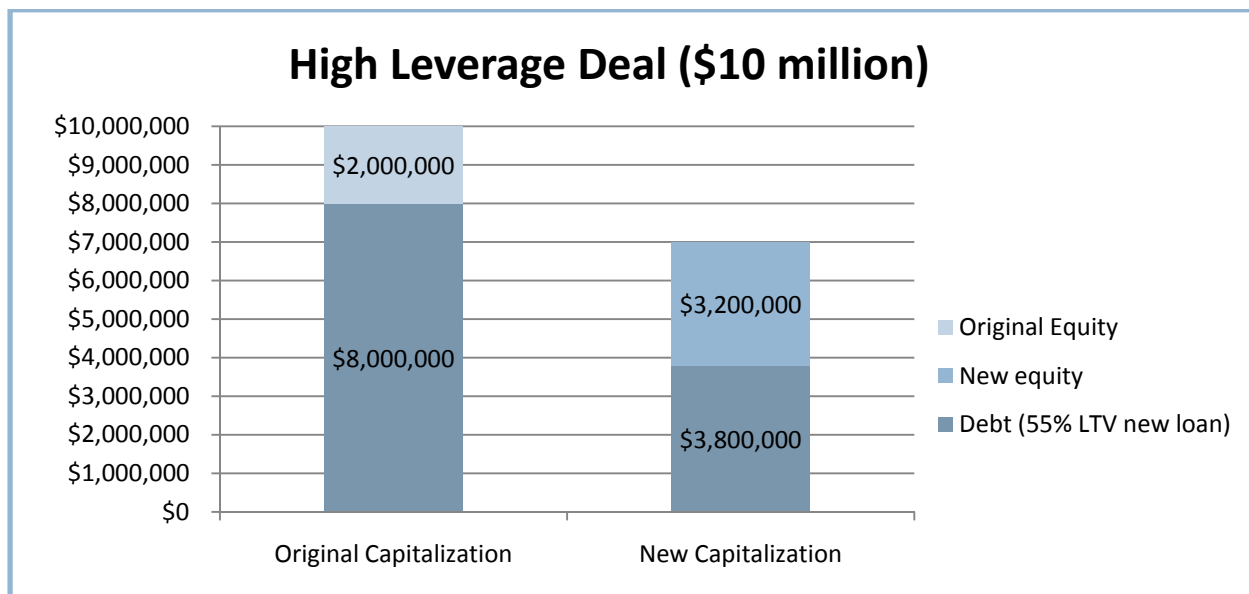
Banks' problem loans have been widely reported, but they have not been selling loans at wholesale prices in great volume to raise capital. Some experts speculate that banks have been reluctant to take aggressive write-downs on their loan portfolio, because such write-downs would seriously jeopardize their capital; they have been more likely to "extend and pretend" that the loans are collectable at book value. Also, banks have been waiting to see how the alphabet soup of government programs (TARP, TALF, PPIP) will evolve; no bank wants to make distress sales when there might be a better buyer in the future in the form of the federal government. In addition, the nineteen largest banks who were stress-tested increased their capital base by selling \$65 billion of equity shares in the 30-day period following the test results on May 7, 2009¹⁷. Finally, many experts speculate that banks may be able to earn their way out of this crisis in lieu of selling discounted loans to raise capital; their current very-low cost of funds provides them with handsome spreads on new loans, and given enough time they may be able to increase their capital base without selling loans at a discount.

CMBS lenders have unique issues when a loan which gets into difficulty. When a CMBS loan goes into default, the administration of the loan is transferred to a "special servicer". Pursuant to the terms of the REMIC trust agreement, the special servicer is mandated to maximize the economic value of the loan. However, the special servicer has considerable latitude in how to maximize the value, and so may be inclined to grant extensions if they believe that the existing borrower can create more future value than an immediate foreclosure and quick sale to a third party in a depressed market. Since the special servicers are frequently also the holders of the junior tranches of the CMBS pool, they have an additional incentive (some would say bias) to allow relief for the existing borrower, rather than to foreclose and recognize an immediate loss. The holders of the senior tranche securities might favor strict enforcement of the terms of the loan, resulting in foreclosure, because they may be in a position to receive all of the proceeds from the sale, to the detriment of the junior tranche-holders. There is considerable debate going on about this "tranche warfare", which has been spurred by the recent increase in the default rate on CMBS loans. However, in the meanwhile, special servicers are granting extensions, which somewhat delays the process of bringing these distressed deals to the market.

C. EFFECTS OF A REFINANCING SHORTFALL

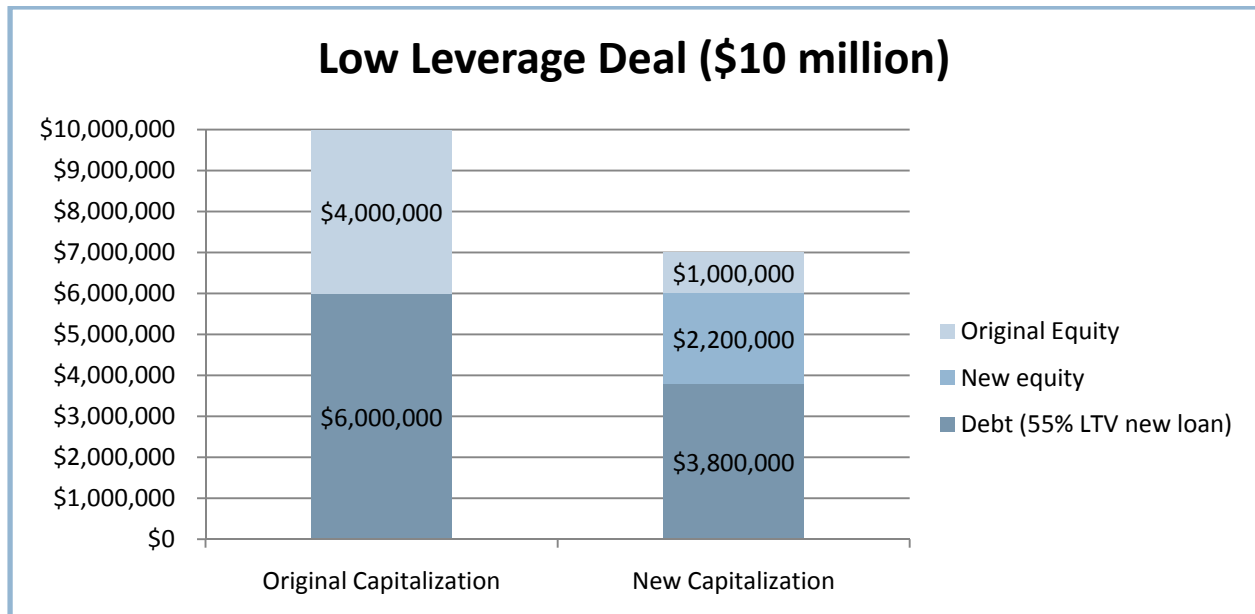
With the wide range of real estate capital structures which have developed over the past decade, there are a commensurate range of re-capitalization requirements. Two major trends prevail: commercial real estate values have declined, and loan-to-value ratios have declined. The de-leveraging problem depends on the extent of leverage which was used in the past.

Figure 8



This chart depicts a \$10 million property, where the investor borrowed 80% of the acquisition cost. In this example, the value of the asset has decreased 30%, due to a reduction in the NOI and/or an increase in the cap rate. Like many of the investments made in the run-up of 2003-2007, the original equity is wiped out, and the property is not worth the balance on the loan. The loan may be in default either for non-payment or because it is past due.

Figure 9



Even in the high-leverage market of 2003-2007, there were loans made with lower leverage. In this example, the \$10 million property was acquired with a 60% loan. Even if the loan is current, when it comes due, there will be a refinancing short-fall. Assuming the value of the property has declined the same 30%, in the current debt market the property may only qualify for a loan of 55% of the value. The result is that the existing owner may have lost 75% of its original investment, and may have to increase its original investment by approximately 50% to refinance the property.

D. NEW INVESTMENT OPPORTUNITIES

The colossal refinancing shortfall projected for the next five years will cause wide-spread disruption in the U.S. real estate capital markets. There will be an opportunity to purchase quality real estate from highly-motivated sellers (REO lenders and/ or over-leveraged borrowers). In a February 2009 report RREEF Research wrote:

“RREEF Research believes that highly attractive opportunities will be available, allowing investors to buy early into a recovery ... Exceptionally high quality properties are expected to be available at historically low pricing. Any underwriting for such acquisitions will need to recognize that real estate fundamentals will be quite weak over at least the next two years.”

The run-up in real estate investment and lending in 2003-2007 went across most major metropolitan areas in the U.S. and all product-types (office, industrial, retail, apartments, hotels, etc.). Therefore, distressed opportunities in the next five years will be found in most markets and product-types. The form of the opportunity will depend considerably on the existing capital structure of the property. Following are a few (but not all) of the possibilities:

- Purchasing REO from lenders after foreclosure
- Purchasing performing debt at a discount
- Purchasing non-performing debt at a discount, with or without a deed-in-lieu agreement (so-called “loan to own”)
- Purchasing existing mezzanine debt at a discount
- Providing new mezzanine debt to cover a refinancing shortfall
- Joint venture investment to cover a refinancing short-fall
- Outright purchase from an owner who is facing a refinancing short-fall

There are numerous investors making plans to take advantage of the coming opportunities . The trade press frequently reports new funds in organization, soliciting new investors. However, it is not clear how much capital has actually been raised or can be raised. Commercial Mortgage Alert published a list in March 2009 of 73 distressed debt funds in formation, planning to raise \$48.4 billion. However, at that time only \$23.7 had been committed, and only \$4.4 billion had actually been invested. Clerestory Capital (a New York fund-of-funds manager) did a study in April 2009, in which they identified 121 funds in the market trying to raise capital, with a total target of \$100 billion. Their survey found 31 opportunistic funds which had held final closes in a total amount of \$18.5 billion in the prior six months. They reported 28 new funds had been launched since October 2008. However, they also reported that 32 opportunity funds had decided to put their plans on hold (cumulative target of \$23 billion), because of difficulty in raising the capital.

There are several reasons frequently given for the difficulty in raising new capital:

- Many large pension investors have seen the value of their securities portfolios decline, with the result that their real estate investments now constitute a larger proportion of their total portfolio than their target allocation (the “denominator effect”).
- It is somewhat difficult for fund managers to convince investors to come into a new fund, when the same manager lost money for them on their prior fund(s).
- Some investors are skeptical about investing at this time, anticipating further market declines.
- Many investors are keeping their capital liquid in order to satisfy requirements in their prior legacy investments.

E. FINDING INVESTMENT OPPORTUNITIES

Successful investors in the next few years will have to be experienced and responsive. Sellers of distressed assets will accept a lower price if they believe that the buyer provides certainty of closing. To be competitive, the buyer must have readily-available funds. In addition, however, the successful buyer must have the experience to evaluate and underwrite an investment very quickly, because a quick closing will be a profound competitive advantage.

Finally, successful investors must be well-connected in the investment community. The key to finding good investment deals is to be on the “short-list” (the shorter the better), when the process of selling an asset starts. Therefore, the successful investor needs to be in constant communication with the major sources of transactions:

- **Intermediaries:** This category includes real estate brokers, mortgage bankers/brokers, and investment bankers. The vast majority of deals in the U.S. are made through brokers, so the opportunistic investor needs to maintain excellent broker relationships. There are obvious national platforms (CBRE, Cushman & Wakefield, Colliers International, Grubb & Ellis, Eastdil Secured, Holliday Fenoglio Fowler, Northmarq Capital, and the like). Maintaining contact with these firms is relatively simple, because they are well-known. However, in every market there are also regional and local firms who are extremely expert in their own territory; discovering which are the influential firms is a challenge. Usually 80% of the transactions get done by 20% of the brokers; the key is to determine who are the 20%.
- **Lenders:** Approximately 54% of all commercial loans are owned by banks, and 24% are owned by CMBS lenders. The ten largest banks own approximately 21% of all outstanding bank loans¹⁸, so an active investor needs to be in constant contact with the largest banks, as many as practical. Virtually all CMBS loans will go into special servicing before they get foreclosed or sold at a discount, so an active investor needs to be in contact with the special servicers. Fortunately there are only approximately 50 special servicers in the U.S., so maintaining contact with them is a manageable task.
- **Borrowers:** There are numerous large investors who will need additional capital to refinance their loans as they come due in the next five years. This category includes REIT's, private equity funds, large investor/developers, etc. A recent study by Ernst & Young found that private equity fund managers' single most important issue for the next two years is refinancing their existing debt. Several REIT's have sold off properties to raise cash to de-leverage their balance sheets. It would be impossible to pursue the myriad of smaller owners in every SMSA; that task relies on broker contacts. However, an active opportunistic investor should be in constant contact with a number of large national owners.

F. CONCLUSION

There are approximately \$1.4 trillion of commercial real estate loans coming due in the U.S. in the next five years. The systems which created this debt, banks and CMBS, do not appear to have the capacity to refinance all of this debt. Moreover, we can expect the effects of the recession to influence real estate values long after the economy begins to improve. Some of the loans will be refinanced in orderly fashion. However, there will be a significant proportion which will require additional capital to facilitate the deleveraging of the industry. This will present a problem for the existing investors (and their lenders) and an opportunity for new capital to make attractive investments.

Wallace G. Murfit
1900 So. Norfolk St. #350
San Mateo, CA 94403
Phone: 650-577-2323
Mobile: 650-867-3399
Email: wallacemurfit@gmail.com

June 30, 2009

FOOTNOTES

1. GlobeSt.com/Real Estate Roundtable, 4-16-09
2. Private Real Estate Equity/Foresight Analytics, 3-20-09
3. Wall Street Journal , 5-28-09
4. Wall Street Journal, 5-28-09/CNN Money.com, 5-26-09
5. Eastdil Secured
6. Wall Street Journal , 5-28-09
7. CNN Money.com, 5-26-09
8. Wall Street Journal, 5-19-09
9. Wall Street Journal, 3-26-09
10. Commercial Mortgage Alert, 5-8-09
11. Wall Street Journal, 3-31-09
12. NY Post, 6-10-09/ Private Equity Real Estate, 6-11-09
13. GlobeSt.com, 6-12-09
14. GlobeSt.com, 6-15-09
15. North Bay Business Journal, 6-15-09
16. San Francisco Business Times, 6-12-09
17. Wall Street Journal, 6-3-09
18. SNL Securities/Eastdil Secured/Wells Fargo