nerej
CELEBRATING 55 YEARS EST 1963

Default rates & demand for debt restructuring expected to rise

November 17, 2009 - Front Section

Real estate industry gatherings are increasingly making comparisons between today's precipitous market declines and the downturn of the 1990's, but there are widely differing views as to the expected severity and duration. Main steam economists and Federal Reserve chairman, Ben Bernanke, point to emerging green shoots and a repairing stock market as hopeful signs of recovery. However, local real estate professionals, venture capitalists and private equity investors in the trenches still see a very "tentative" investment environment and a serious lack of economic activity on most fronts.

Positive national news has been largely limited to expense-cut driven gains in the stock market and relief among regulators that the "panic phase" of the global capital market meltdown is over. But, such gains have been achieved at the expense of decimated employment ranks, tightened credit markets and a relaxation of accounting standards for valuing troubled loans. Suspension of FASB mark-to-market guidelines and cancellation of Treasury's PPIP (Public Private Investment Program) program in late spring 2009 was viewed by regulators as a requisite step to averting further major bank failures and market chaos. But, the measures also dramatically slowed the loan resolution process, created further uncertainty concerning asset values and effectively pre-empted market clearing mechanisms that could have started to create pricing floors in transaction activity.

In New England, the initial impact was immediately felt in reduced corporate spending, retail sales, hotel demand and employment. Complementing these dynamics were renewed pressures on mutual fund operating margins and fee structures, wide-spread cost cutting across most business areas and professions, constraints on private education outlays due to eroded endowments, further containment of health care costs and intensifying budgetary pressures on state and municipal employment and services. A year later, the local economic chill has turned into a far more persistent and protracted problem than many had expected. Private conversations are shifting away from "if" to "when" the downturn will result in increased real estate financial distress and loan defaults.

Currently, on a national level, CMBS loans which represent approximately 25% of the $3.1 trillion commercial debt market are experiencing delinquency levels of 5%. The Northeast loan delinquency rate of 3.2% is expected to increase significantly, now that unemployment levels are poised to exceed the national average. As of November 1st, almost 8% of all CMBS loans, or $57 billion, are now in special servicing. Hotel, multi-family and retail assets are the most distressed product types with special servicing levels of 14.7%, 10.1% and 9.1%, respectively. Only 4.4% of securitized office loans, which make up 30.1% of all CMBS issuance, are in special servicing. But special servicing volumes for office loans should increase markedly over the next 24 months as rising cap rates coupled with declining net operating income from lease roll over exposure drives down asset values and increases distress.

The average delinquency rate for bank "core" commercial real estate loans nationally is approaching

4.5%. However, real estate loan exposure among regional and community banks is typically much higher than that of the largest national banks.
Also, the regional and community banks are typically under-reserved for expected loan losses and are thus particularly vulnerable to a protracted, deep recession.

The New England region is now entering a phase of the real estate cycle where over-leveraged assets and capital-constrained operators will struggle to compete. Net effective rents have declined from 20% to 40% for retail and office space and the costs of retaining or attracting new tenants is rising. Multi-family properties are experiencing record high vacancy levels and hotel occupancies and rack rates are at 20 year lows. Owners of distressed assets will find their options increasingly limited as protracted indecision and the lack of a cohesive, credible workout and restructuring plan will leave these borrowers particularly vulnerable to deteriorating performance and the potential for foreclosure.

Along those lines, Paradigm-Exeter Advisors was recently engaged as portfolio manager for the first CMBS-related receivership in New England. The firm's initial responsibility is to stabilize this portfolio of nine suburban office and flex properties totaling 500,000 SF. The assets are located in the greater Boston metropolitan area and Paradigm-Exeter Advisors will soon help the receiver commence with managing the orderly liquidation of these assets.
Dana Rowan is managing director of Paradigm-Exeter Advisors, Boston, Mass.