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Stressed commercial real estate winding down, or not?

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We are on the eve of financial reform, as Congress reviews legislation to provide greater regulation in lending. It seems appropriate to comment on commercial real estate at this historic moment, as there will be much refinancing over the next five years, based upon the types of loans that were provided during the mid 2000's.

To give context, there were many articles about 18 months ago predicting a commercial real estate collapse over the next several years. The articles correctly cited the following causes:

*Over development during the mid 2000s.

*Easy lending, typically caused by the securitization process.

*Assumptions that the booming economy and rising rents would continue.

*Actual growth in unemployment, taking rents in the opposite direction.

*Increasing vacancies.

*Substantial amounts of loans coming due between 2010 and 2015.

This was certainly compelling evidence. I wrote about that time saying I generally agreed, but our government was throwing so much money at the residential problem that I assumed it would do so for commercial real estate as well. Evidence to the contrary, I wasn't convinced that commercial real estate would crash.

In doing research for this article, I found that not a whole lot has actually deteriorated in the ensuing year. This is actually a year of relative inactivity, where bankers chose not to foreclosure on properties. Instead banks, with the willingness of regulators, have been more able to negotiate and rework loan terms, as both lenders and debtors hope the market will turn. It has been the year of "extending and pretending".

It is true that there are many more banks, typically small, on the "watch list" this year than last year. (275 in August 2009 and approximately 960 currently). And some banks are being closed at varying rates averaging 5 to 15 closures per month. Certainly this will have an impact on many small commercial real estate projects built in ways and areas that they never should have been. However, compared to a market of approximately $3.5 trillion of commercial loans outstanding, these closures will make a relatively small dent.

For all the gloomy talk, the problem seems relatively well contained. Banks have already recognized about $50 billion or about 60% of estimated loses. Moody's Real Commercial Property Price Index indicated that after 13 months of consecutive declines in commercial property, values stabilized and even increased slightly.

It seems to me, we are either on the cusp of a successful policy of "extend and pretend," or set for a new surge in problems. The real determinating factor of success is whether or not the economy has turned around. If unemployment continues to stabilize and even decrease, then there will be investment in people and resources which will translate into demand for office space. There has been relatively little if any construction of new space since 2007, and although there is substantial available space, supply is essentially constrained for the next several years.

If on the other hand, the opposite ensues, with a potentially dreaded double dip recession, all bets are off. There is a potential for realized loses of upwards to $300 billion in commercial property loans, and this could create a downward spiral of further economic contraction, further job loses, and failure of more banks that can no longer "extend". That scenario, combined with new regulation in lending will further restrict small business access to capital, and thus cause even less interest in occupying commercial real estate.

In short, I don't see any clear path. There is far too much uncertainty for anyone to be predictive. Unfortunately, as much uncertainty as there was a year ago, there continues to be the same as this time. Depending upon many factors out of peoples' control, many people will be right, and many people will be wrong.

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