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Distress or no distress in the office market?

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As the national economy begins to emerge from the Great Recession, the big question facing the real estate investment world is: 'Will there be a distress cycle?' There are many conflicting signals, some suggesting that the market has passed or avoided this cycle and others pointing to looming challenges. From the capital markets, we see that REIT share prices have made a robust recovery, and REITs have raised over $33 billion since the beginning of 2009. CMBS spreads have narrowed significantly from the uncertain days of early 2009. Lenders are expressing an increased willingness to lend, and their spreads have tightened. In the transaction markets, with Boston buildings like One Brigham Circle and 10 Brookline Place trading at surprisingly low cap rates, it is getting a lot easier to believe that the worst may be over. The leasing market has also scored some victories lately, at least in certain submarkets.

With those positive signs, it might be time for the industry to breathe a collective sigh of relief... until we turn our attention to the general condition of the property markets, which offer the opposite side of the coin.

Right now, the property markets are extremely weak, and, while the bottom is definitely nearing, we are not all the way there yet. As office leases continue to reach expiration in a still fragile economy, there is risk of a further uptick in vacancy or, at a minimum, the high probability of rolling in-place rents down to the new lower market rent levels. With few economists forecasting sustained near term job growth, many industry players expect that shadow inventory will trickle onto the market, causing the glut of empty space to grow or inhibiting the rebalancing of supply and demand and delaying any upward movement in rents. For a while longer, NOI will continue to fall for many properties, and, in lots of cases, it just won't make financial sense for Landlords to put fresh capital into buildings with high levels of debt. As these factors put additional stress on NOI, debt service is going to be increasingly difficult to cover for many buildings. So far in this cycle, with lenders able to 'pretend and extend' maturing loans that are covering their debt service on buildings that have seen 20-30% declines in market value, we haven't seen much restructuring or foreclosure activity, but these looming payment defaults present a different set of challenges for banks and CMBS special servicers.

So, distress or no distress? We at Paradigm like to say that in a battle between the capital markets and the property markets, the property markets will always win, so we are decidedly in the camp of those who think a distress cycle is coming. We just don't see a robust enough recovery in the economy to spur fast enough improvement in demand for space to solve the problems of overleveraged assets with maturing loans, lower NOI, and values that don't permit recapitalization at the prior levels of debt. It's only a matter of time.

How will the cycle play out? While we do not expect a repeat of the RTC days of the early '90s, with deep 'crash' and a flood of troubled assets saturating the market, we do anticipate that lenders -

particularly banks, but also CMBS special servicers, and even life companies - will act more aggressively on their troubled loan portfolios and eventually move distressed assets onto the market. Trading volume will increase during the balance of 2010 and on through at least 2012. In fact, along with the arrival on the market of 'core' and ultra-core' assets this year, we are already seeing a slight uptick in 'distressed' deals.

At some point in the cycle, profitable banks will realize that the hassle of managing their distressed portfolios (loans and REO) will no longer be worth the potential upside of holding them, and their strong P&L's (being a lender in a time of 'zero' cost of capital and a recovering economy is generally profitable!) will give them the ability to take charge-offs on the balance sheet. Stock analysts and investors will demand clean bank balance sheets and reward banks for dumping troubled assets, just as they did in the mid-1990's. As it always does, the market will eventually clear - it's just taking a little longer this time.

In our view, we are approaching a great time to invest in real estate. The distress cycle is coming, and investors who are prepared to pounce on and then work hard to add value to the coming deals will be rewarded with the opportunity to acquire assets at an attractive basis. The best time to buy anything is at the bottom of the cycle and we are approaching that point. And, while 'distress cycle' sounds terrible, it usually ends up being a good thing. The real estate party of 2005 - 2007 was fun, but it wasn't particularly healthy. Barring a catastrophe in the economy, the next 3-4 years will get us back to a better place.

Kevin McCall is the president and CEO of Paradigm Properties and Paradigm Capital Advisors, Boston.