



nerej

Daniel Calano - Clearing the commercial market, without foreclosure bloodbath

May 12, 2011 - Appraisal & Consulting

There was a lot of evidence about two years ago that securitized commercial debt was coming due, and would likely not be newly underwritten at the same values as it once was. Financial markets were frozen and new loan covenants were more restrictive. On top of that, businesses were cutting back, needing less space, and rents were beginning to slide. The future looked dismal. It looked, in fact, that there would be the devastation that occurred in the past major real estate recession in the late 80's and early 90's, where pages of the newspaper every week were filled with foreclosure activity. Back then, the federal agencies such as the FDIC and newly created RTC and Recoll had strict rules about loan to value and debt coverage ratio, and if you didn't meet them, foreclosure was the solution. If you weren't making payments, there was even less mercy.

About one year ago, however, I wrote an article doubting whether we would have the same blood bath, even though the amount of current debt was as least as high as in the past, and 2010 values had fallen well below debt coverage and loan to value rules. I believed there would be a different approach to commercial loans this time around. Congress and the President were railing against home foreclosures. Unlike the early 90's, the government was actually putting pressure on lenders to stabilize the market, perhaps to sell the loan at a discount, but not foreclose property. I believed that there were forces extending the concept to commercial loans, and commercial property owners would be allowed to hold their properties through the inevitable dip in commercial real estate and survive until the next upswing. I thought it would be a good thing.

Fast forward to recent news, and it is clear that "extend and pretend" has won. Recent statistics show that, through February, foreclosures, particularly in typically strong areas such metropolitan areas of the east and west coast, have been fewer and farther between. Year over year, 2010 shows a reduction in foreclosures over 2009 figures. Moody's has said that the pace of growth in delinquencies is slowing, climbing less than in the past two years. 2011 is showing an improved economy with modest job growth or replacement, indicating some new need for space. Further, there has been no new construction recently, supply is tightening, and rents are beginning to increase.

Add to these improving circumstances, the very strong need for investor yield. There are very few areas for investors to place money. CDs are down, municipal bonds are out of favor, and while the stock market is competitive, people tend to think of it as more speculative. Many are investing in commercial real estate, thinking that they are at least at the bottom and there is upside in rents and therefore residual sales prices. In prime areas, values have risen by 30%. Almost all agree there will

no double dip in the economy; to the contrary, by all measures things are on the rise. The market is clearing for the right market reasons, not by a panic induced bloodbath.

Commercial real estate is controlled by far fewer people than residential, who are as a whole probably better capitalized. By its very definition, home ownership includes over a 100 million people, whereas commercial real estate is concentrated in far fewer owners. In a sense, commercial real estate is too big to fail, and easier to help. If they could, elected officials would probably like to "extend to pretend" to home owners, but there are far too many, too disparate, there are too many different stories as to why their houses are under water. Commercial is more manageable.

Some would argue that failure and foreclosure would have cleared out the market and allowed for a faster equilibrium. But lenders have decided to stick with their original horse, rather than risking a ride with a new one. Foreclosure is costly for all, and does not really solve the underlying problem. It shifts it, or rearranges it, sometimes for new buyers with less experience, certainly with regard to the foreclosed property. It seems prudent to keep strong investors and developers even when the properties are problematic. They know how to manage the property, and they have incentives to hold it into a predictable upswing.

Daniel Calano, CRE, is the managing partner and principal of Prospectus, LLC, Cambridge, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540