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## **Now is the time to look for physical, tangible assets like comm'l. buildings as better investments**

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The New Hampshire commercial real estate sector is examining the changing funding environment daily. The melt down of first the sub prime (residential) markets, now the big Wall Street investment banks, conduits and now AIG Insurance—the biggest provider of interest rate swap insurance, seems more national and global than regional. However, as Tom Freidman preaches, the world is flat so there are connections.

There are a number of properties in New Hampshire that have been financed into conduits, bundled into CDOS and even into derivatives. These new finalization tools are very complex and frankly no one knows how this will unravel. Most of the commercial real estate transactions in New Hampshire (the estimated average value is under \$5m) are done with traditional (local) bank financing. Many that are owner occupied may use the SBA's 504 loan program. Larger properties do move out of state and hence are more likely to be folded into more complex instruments.

The key reason is recourse. Most bank loans and mortgages come with a guarantee (personal or corporate, and for small corporations, a corporate guarantee is often secured with person obligations of the principals). Successful business people do not like to give personal guarantees if they don't have to. Many feel they have established good credit in their businesses and loans for the business should stand by themselves. Avoiding personal recourse is important to many borrowers.

The conduit concept is a securitization of a pool of loans or mortgages. Simplistically, if one bundled 100 apartment building mortgages from all around the country, the advantage would be geographically dispersal. So is the Gulf Coast was hit by a hurricane and two properties became non performing, the other 98, not in the Gulf region, would still be performing.

Another tact was to mix property types. So apartment buildings, office buildings, industrial and warehouse properties would all be bundled, perhaps with retail mall properties. If office buildings became soft or non performing, the other properties would carry the bundle. The concept was to mitigate risk. If risk is reduced, the return or rate being paid on the mortgages could be less. This was deemed a win/win.

Now the next step was to mix property types and have geographic dispersal. These loans would be bundled or aggregated. Let's say 100 \$1m loans were bundled and they averaged 6.5%, the bundle would yield \$6.5m per year. Someone has to collect the payments and administer the loans so they get a fee. But this seems to be a low risk investment so some folks might agree to accept a 5% annual return to own part of the loan portfolio. So far, so good. But if \$1m works, why not \$5m or \$1b or \$10b? Economies of scale, right? Well that is a lot of properties spread all over the place and there are a lot of logistics in documenting, cataloguing and keeping track of 1,000, 5,000 or 10,000 loans spread over 50 states. So maybe some loans slip into the bundle that are not up to snuff or are not fully documented, or . . . you get the point.

The early returns of these products were very well received in the market and more investors sought to buy them. Money flowed in and the volume and speed of delivery the bundled loans increased. The documentation and due diligence could not keep up and the quality slipped.

Fast forward and the bundlers of these loans are pulling them in but the markets get skittish and they cannot sell them so fast. So suddenly they are carrying lots of these loans on their books. The music suddenly stops and they are over extended. Other larger, banks won't loan to them overnight or short term and we suddenly are in a liquidity crisis. Up steps the Fed and says, don't worry, we will help out. We will make x billion dollars available to keep the music playing.

Well, I am clearly over simplifying, but the point is these new instruments grew so fast, no one understood that the music might suddenly stop and that many of the players would not have a chair to sit in when it did! Now residential and commercial mortgages are not the only things that were securitized. Lots and lots of credit and debt, car loans, used car loans, student loans . . . were too. So we cannot see bottom yet and this could go on for a while. Not knowing causes uncertainty and with uncertainty comes anxiety.

Today there is a great deal of anxiety and that makes people pause before making real estate decisions. So the markets slow down and folks cut back on spending and investment and if there is too much of that for two quarters, then we are technically in a recession.

Not to worry, the Fed will turn on the spicket and infuse liquidity or loan money for one institution to buy another, or loan AIG \$80b! Normally that stabilizes the markets and the music cranks up and off we go. But sometimes the demands are so many that the fixes take longer to work. That seems to be what we are facing now. The sheer volume of dollars we are talking about and the number of Wall Street firms needing shot gun marriages or bail outs is huge. It will take quite some time for the markets to clear and get back on track. How long? Maybe a year, maybe more.

One thing is certain, folks are looking at physical, tangible assets like commercial buildings as a better investment than a share of a mortgage REIT. This correction has been due and hopefully the values will stabilize soon. I called Ben Bernanke to ask him when, but the message on his machine said he was very, very busy right now and he would not be answering any messages for the foreseeable future!

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