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The second shoe to drop: A boot or a slipper?

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It's yet another anniversary that has come upon us very quickly. This month is about one year since our financial system really blew apart, marked by the failure of Lehman Brothers. The recession is actually almost two full years in swing, having officially started in December of 2007. There are signs that the economy is recovering, including a rebound in the stock market, an improvement in housing statistics, and a modicum of consumer confidence. However, there are still drags on the recovery, specifically and most importantly, unemployment which is growing and will probably exceed 10%.

There are three schools of thought regarding the pace of this recovery, proposed by as many pundits as there are people: fast recovery, slow recovery, and double dip recession. In other words, nobody knows, and the best experts readily admit it. For the most part, uncertainty is based upon lack of previous model, since this recession is punctuated by extremely tight credit on the negative side, but also trillions of dollars of stimulus money presumably on the positive side. Nobody knows which will have the most impact.

Not knowing as much as the experts, who admit they know nothing, I am focusing on my piece of the pie which is mostly tied to commercial real estate. Everybody has used the trite phrase that commercial real estate is the second shoe to drop, primarily caused by the tight credit notion. There is about $1.5 trillion of commercial real estate debt. When commercial real estate value was at its high point in 2007, over $250 billion of that debt was financed through securitization, where loans were assembled into packages, divided and sold on Wall Street to individual investors. Securitization provided a very popular alternative to traditional lending and debt was relatively easy to come by, at high loan to value ratios, and low borrowing rates, and securitization led the parade.

With rents dropping now, in some part due to employees being laid off and companies shrinking, commercial real estate has lost value. Some say as much as 35%, depending upon location. The fear is that this will get worse as these loans, which were often for 5 to 10 years, become due over the next few years. Securitization of loans no longer exists, and credit is much harder to come by, with more traditional banking and insurance companies as the only source. Small banks will loan only up to $10-$15 million. Insurance companies may loan more but at greater expense to the borrower. Finally, loans are typically going to be about 60% of property value, as opposed to 80 or 90%, requiring major unforeseen shots of new equity.

All of pieces are in place for a potential perfect storm: difficult lenders, fewer venues for debt, and a peak demand for refinancing. The worriers therefore fear that prices that have already come down due to lower occupancy, will fall further due to difficult refinancing and potential foreclosures. In discussing the issue with mortgage brokers, I come up with a similar comparison to the previously mentioned "fast, slow, or no recovery" conundrum. Most people are simply uncertain. It is true that the storm could happen, and commercial property would follow the path, if not the magnitude, of residential real estate. On the other hand, the same stimulus programs that have provided support

under residential, combined with some new ones specifically geared towards commercial, may stabilize things much more quickly. In all likelihood, those building owners who are able to come up with additional equity, and who have performing properties, will probably be able to refinance or extend their loans. In addition, the government is well aware of the potential problem, and has already extended a low cost loan program to banks and investors willing to purchase existing mortgage-backed securities. There is even talk of the potential of variances on the old source of securitized debt reemerging.

My guess is that, with our recent experience and knowledge of how negatively things can unfold, government, banks, and Wall Street will find ways to finance much of the good commercial real estate that exists. Clearly, properties that are failing of their own accord, with low demand and lower rents, and which perhaps should not have been built, could fail. This will be newsworthy, but may occur in such disparate places and in small enough volumes that there will not be the kind of panic that occurred in residential real estate. But this is a guess. Since nobody knows, only time will tell.

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