

❖ The End of the Great Recession and the Next Great Exchange of Commercial Property

“Over the next few years, a wave of commercial real estate loan failures could threaten America’s already-weakened financial system. The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation’s mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy... Between 2010 and 2014, about \$1.4 trillion in commercial real estate loans will reach the end of their terms. Nearly half are at present, underwater, that is, the borrower owes more than the underlying property is currently worth. Commercial property values have fallen more than 40 percent since the beginning of 2007. The largest commercial real estate loan losses are projected for 2011 and beyond; losses at banks alone could range as high as \$200-\$300 billion.¹”

- Congressional Oversight Panel, February 2010

“If the market value of an asset declines, then the unit owning the asset has a realized or unrealized capital loss depending on whether or not it sells the asset. These capital losses decrease the net worth of the unit if we measure all asset values as current market values. This decreases the unit’s ability to borrow. If the decrease in the market value of the assets it owns is so great as to make the net worth of the unit negative, then the owners of the unit’s debt liabilities will choose to exercise whatever powers they have to force payment, and certainly a negative net worth unit will not be able to get its debt extended or refunded. Hence, the decline in the market value of assets, by decreasing the protection that a unit’s net worth provides for the lenders, decreases the likelihood that a unit which needs to acquire cash by issuing its debt can do so.

The effort to meet money flow commitments by selling assets is a crucial step in the process by which financial distress is generalized into a financial crisis. If a unit needs money and the only way it can acquire money is by selling its financial or real assets, it is putting pressure on the market for this asset. Its actions will tend to lower the price of the asset. If other units are in the same predicament, then the price of the asset will have to fall until there are units which are willing to take a position in the asset. However it is not only the units in need of money which are suffering financial losses because of the decline in the market value of this asset, but all units that own this asset.²”

- Hyman Minsky, 1964

¹Congressional Oversight Panel - February Oversight Report, “Commercial Real Estate Losses and the Risks to Financial Stability”. February 10, 2010.

²Hyman Minsky 1964, Financial Crisis, Financial Systems and the Performance of the U.S. Economy



Michael J. Acton, CFA

Managing Director &
Director of Research

AEW Capital
Management, LP



For the second time in two decades, commercial property in the United States is fully experiencing a “Minsky moment”. The cycle of falling asset values which triggers margin calls on inappropriately leveraged assets has begun and, as the Oversight Panel’s report portends, a much larger period of asset recapitalization lies ahead. Regardless of whether it is caused by excessive speculative construction as in the 1980s or by the historic declines in employment levels that we are experiencing today, rising vacancy rates in commercial properties lead directly to falling rents and declining property income. In and of itself, falling income is disagreeable for investors seeking a return on their capital. However, when combined with capital structures that were not designed for extreme economic events, the situation turns tragic as asset level income is no longer able to service the debt that encumbers the asset. From the investor’s perspective, the asset effectively dies as the investor’s equity is destroyed. In contrast to Stalin’s infamous observation that one death is a tragedy, but a million deaths are mere statistics, the loss of one over-leveraged property, while perhaps tragic for that specific investor, is irrelevant to the broader economy and financial system. When repeated simultaneously across thousands of properties, the consequences become potentially disastrous for the broader economy and financial system.

Congress is clearly worried, with good reason, that the impact of so many loans reaching maturity (or default) in such a compressed time period may create a “contagion effect” as many of Minsky’s “units that need money” are forced to liquidate at the same time. Specifically, the Oversight Panel is concerned that continued problems with commercial property loans will further constrain banks’ ability and willingness to lend.

Between 2004 and 2007, hundreds of billions of dollars of commercial property loans were originated fueling one of the nation’s most prolific periods of real property transactions and price appreciation. Over this same period, the share of lending represented by mortgage

conduits, groups producing raw material for securities made up of commercial property loans, exploded; rising from roughly 25% of all origination to nearly 50% of all origination. These conduit lenders grew market share in an expanding market by offering the best rate and best terms, effectively pushing many traditional balance sheet lenders, such as banks and life companies, to lower market share and other lending markets. This concern is particularly acute with respect to the nation’s banks. Over the past decade, banks, particularly small and mid-size banks, found themselves effectively disintermediated from the most profitable areas of lending as Wall Street’s securitization machine dominated the numerous lending markets. In response, many banks turned to their traditional “backyard” enterprises: construction loans and small business loans (often collateralized by the very property owned by the small business). To date, the FDIC has closed more than 150 of these smaller banks and there are more than 550 additional banks on the FDIC “watch list”.

While ominous, the Congressional Oversight Panel’s assessment of the issues surrounding near-term commercial property loan maturities at least indicates that policy makers now acknowledge the scope of the problem and the limited policy options available. Clearly, the end of the “Great Recession” is a positive development from a social, financial, and economic perspective and the problem with pending commercial mortgage loan maturities and defaults would be significantly worse if the economy was still contracting. However, despite the improving economic environment, there are numerous developments that cause the improving economy to be somewhat irrelevant.

1. The extremely large aggregate value of new loans originations during the 2004 – 2007 period, in and of itself, necessitates a future period of an unusually large demand for refinancing capital. Between 2004 and 2007, the net flow of capital into commercial and multifamily mortgages totaled more than

\$1.25 trillion, more than one-third the total of all outstanding commercial property debt.

2. Given the near complete shutdown of the securitized lending market for property, a sector that at one point represented roughly half of all new property lending, there is reasonable doubt that the volume of refinancing capital required can be delivered. Even if traditional “balance sheet” lenders doubled their lending volume, it would cover only a small share of the loans that need to be refinanced.
3. The period of “pretend and extend” loans extensions over the past 12-24 months, while possibly quite rational for any individual lender or servicer, collectively creates a highly compressed time period of maximum refinancing demand; concentrated in the 2011-2012 timeframe.
4. Unfortunately, the 2011-2012 period when refinancing needs will be at a peak coincides with two cyclical phenomena that are nearly unalterable: the cyclical trough in property-level net operating income (NOI) and the next period of interest rate increases.
5. Interest reserves, a common tool of peak-year loan underwriting designed to bridge the gap when current property income did not produce adequate debt service coverage ratios, is burning off and this will only accelerate as property NOI continues to decline.

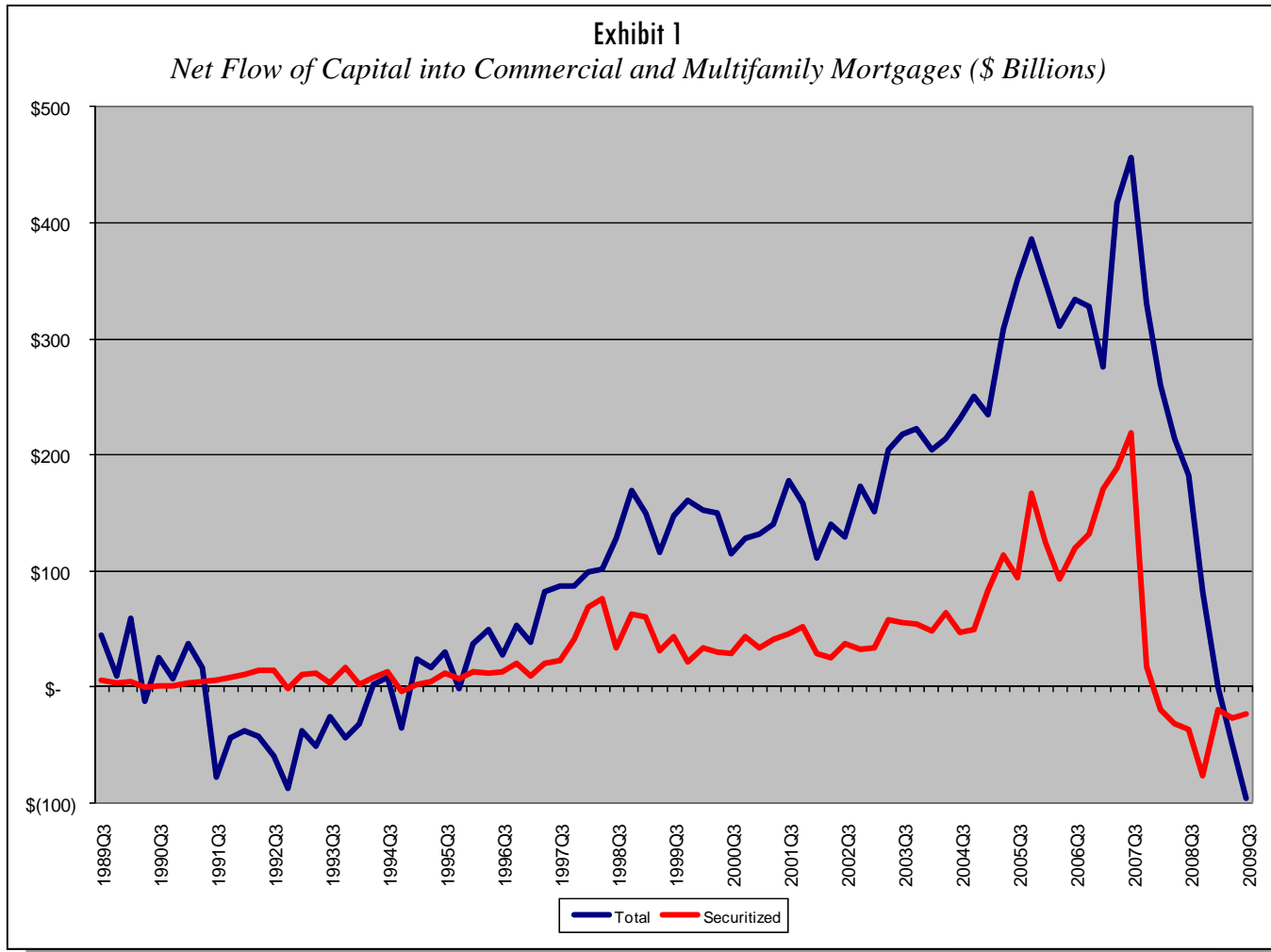
With respect to NOI, commercial property has long been demonstrated to be a “lagging sector”. Employment growth lags GDP growth. Improvements in occupancy lag improvements in employment. Rental rate growth lags occupancy improvement and NOI increases lag rent and occupancy gains. The total lag is typically 12 to 36 months depending on lease structure, properties with shorter lease terms (e.g. apartments) bottom out earlier than properties with longer lease terms (e.g. office buildings), as maturing leases roll to lower market rents. Again, an improving economy will clearly help

form a bottom in aggregate NOI, but the lagging nature of the real estate markets is a near certainty and the trough will occur during the 2011-2012 time period.

The confluence of peak loan maturities and the prospect of rising interest rates creates additional complexities. Many property loans originated in the peak-lending period (2005-2007) were structured as floating-rate loans, typically tied to a LIBOR reference rate. If the recession is really over and recovery has begun, it is only a matter of time before the Federal Reserve begins to raise short rates from today’s near-zero levels. Indeed, the Fed has already signaled such a move at their regularly scheduled mid-February meeting where they widened the spread between the “discount rate” and the “Fed funds rate”; historically a signal of pending increases in other short rates. With unemployment holding at very high levels, it is unlikely that the Federal Reserve will begin aggressive tightening during 2010 and this only makes it more likely that rates will be increasing during 2011 and 2012, the peak period of loan refinancing. Clearly, if interest rates are rising as property incomes are bottoming, numerous properties that are currently covering debt service requirements may be unable to cover their obligations. Additionally, loan proceeds on any potential refinancing will be lower due to the combination of higher borrowing costs and more stringent debt service coverage tests.

With respect to the latter point, the commercial property lending market today is largely in the hands of traditional balance sheet lenders. Today conduit lenders, who so clearly dominated the market just a few years ago, represent a net outflow of mortgage capital as existing loans are not rolled over at the same dollar value (see Exhibit 1, next page). Conduits lenders have in fact moved from providing more than \$200 billion per year of net new commercial mortgage capital to a net negative (i.e. not refinancing maturing loans at existing balances).

The good news is that the traditional balance sheet lender has reemerged in recent months and



Source: Federal Reserve, Flow of Funds

is willing and able to write new loans. This comeback can be traced to several developments. First, the “best rate” conduit lender does not exist today so competition for loans is greatly reduced. Second, many balance sheet lenders were not able to fully deploy prior year allocations due to the dearth of transactions. Finally, with the broad-based narrowing of credit spreads during 2009, many balance sheet lenders simply cannot find attractive yields in other parts of the lending market and the yield pickup in property lending (combined with significantly lower values) makes commercial property lending look relatively attractive. As welcome as this development is, it must be kept in perspective. For example, at the peak of the market in 2007, life companies

represented roughly \$20 billion of net new capital in commercial property mortgages, which is less than one-tenth the level of conduit activity.

While the return of the balance sheet lender is a positive development, the changes in loan underwriting and terms described in Exhibit 2 (next page) illustrate some of the factors that borrowers face when attempting to refinance their properties. More stringent loan-to-value (LTV) and debt service coverage ratios (DSCR) by themselves suggest lower loan proceeds on new loans, and this is further exacerbated when combined with values that are 30% to 40% below peak levels and property NOI 10% to 15% below peak levels.

Exhibit 2			
<i>Permanent Financing from Balance Sheet Lenders</i>			
	Pre-Credit Crisis June 2007	1 Year Ago Jan 2009	Today Jan 2010
Max New Loan Size (individual property)	\$200 M	\$50 M	\$100 - \$200 M
Max Loan to Value (on new valuations)	70-75%	50% - 60%	60-65%
Min Debt Yield – NOI/ Loan Amount	N/A	12-14%	11%
Min Debt Service Coverage Ratio	1.05x (on stabilized income)	1.25x – 1.40x (on income in place)	1.25x - 1.35x (on income in place)
NOI Underwriting	Borrower Pro forma NOI	Current in-place NOI	Current in-place NOI
Spreads over Treasuries	85-125 bps	350 - 500+ bps (7% coupon floor except GSEs)	280 – 350+ bps (5.5% - 6.5% coupon floors except GSE's)
All-in Fixed Rates	5.5% - 6.5%	7.0% - 9.0%	5.5% - 7.5%+ (higher on hotels)
Loan Proceeds	Sized using IO DSCR	Sized using Amortizing DSCR	Sized using Amortizing DSCR
Amortization	10 Years I/O	No interest only	3 Years I/O on 10 Year Loan
Additional Requirements	Minimal	Requires Structuring (holdbacks, earn outs, TI escrows, recourse)	Requires Structuring

Source: AEW Capital Markets

The “Equity Gap” and the Next Great Exchange

The first “Great Exchange” occurred in the late 1980s in the wake of the bursting commercial property bubble as the fundamental mismatch between “long life” assets (property) and the short-term liabilities of banks and thrifts was corrected. The result was the emergence of higher allocations to property by “long liability” capital sources such as pension plans and the development of more liquid equity structures such as a much larger and diverse REIT sector. Today, the amount of equity needed to recapitalize commercial property is stunning. As illustrated in Exhibit 3 (next page), the new equity required to recapitalize an asset from “peak year” lending is nearly as large as the original equity committed. When extrapolated to the entire universe of “peak year” lending, the aggregate sum required could be as much as \$400 billion.

Clearly, this “equity gap” will be closed both by new capital commitments as well as significant recognition of loss by existing lenders. This process will necessarily require a large scale transfer of assets as some portion of existing owners and lenders either cannot or will not commit their capital to these assets. Over the next several years, the U.S. commercial property market will once again engage in a “Great Exchange”. This time, the exchange will not be driven by a need to rematch assets and liabilities but rather as a part of a much larger process of deleveraging initiated by the Great Recession. In time, this process of deleveraging will, in turn, establish the basis for the inevitable next “up cycle” for credit and asset valuations.

Exhibit 3
The "Equity Gap"

	Individual Asset	Total of Peak Acquisition Years
Acquisition Cost	\$20,000,000	\$1,500,000,000,000
LTV	70%	70%
Proceeds	\$14,000,000	\$1,050,000,000,000
Equity	\$6,000,000	\$450,000,000,000
Decline in Value	30%	30%
New Value	\$14,000,000	\$1,050,000,000,000
Equity	\$0	\$0
New LTV	60%	60%
New Proceeds	\$8,400,000	\$630,000,000,000
"Equity Gap"	\$5,600,000	\$420,000,000,000

Mike is a graduate of Bates College (B.A.) and a Chartered Financial Analyst.