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CRE Opportunities, Challenges Extend Beyond Value

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Opportunistic debt and equity for commercial real estate exist in a tight credit market, but analysts say credit extensions pose challenges.

Jay Haberman, executive vice president of mid-Atlantic markets at **A10 Capital**, Boise, Idaho, said his company will lend on unstabilized properties, allow cash-out recapitalizations, provide equity capital and other financing on good properties that are nearly, but not quite, bankable.

“The few commercial real estate lenders that are active in the market today are cherry-picking and will only consider down-the-middle properties with no issues,” Haberman said. “If a transaction has any 'hair', such as an unstabilized property or leasing issues, it’s an immediate pass by conventional lenders.”

But, a strip shopping center that lost tenants—with a good operating history--will get a closer look from A10 Capital.

“It is now at a lower occupancy level than most traditional lenders would consider refinancing that property,” Haberman said. “[A bank or a life insurance company] would need the property more leased up. [A10 Capital] can consider that property in its current, unstabilized condition.”

Haberman said many banks—similar to life insurance companies in the early 1990s—will need to begin to discount loans that do not fit their lending parameters and remove them from their books. He said the “delta between the bid and the ask is narrowing” with more capitulation on the seller side than buyer side. However, with few transactions, he said the gap needs to narrow further for the market to heat up.

“[Banks] certainly have a lot of commercial real estate on their books," Haberman said.
"There is no argument there. A lot of the loans they did make, especially from 2005 to 2007 to keep up with the CMBS markets, were probably outside of their comfort zone--to say the least."

However, the **Federal Deposit Insurance Corp**. provided guidance last year for banks to extend commercial mortgage maturities—if prudent—on income-producing properties despite underwater property values, poor fundamentals and a weak economic outlook. Some industry analysts use the phrase “extend and pretend,” meaning that prices do not hit true market value without seller capitulation.

“It delays the inevitable,” Haberman said. “My theory is to take the lumps now, get rid of the assets that are no longer core--or do not fit the lending strategy--and take the loss.”

In the early 1990s, the federal government seized failed savings and loans institutions and formed the **Resolution Trust Corp**., which sold off commercial mortgages to the highest bidder. The “massive oversupply” of properties secured the loans but, unlike that time, the recent recession on average did not have excessive overbuilding, said **Dan Fasulo**, managing director at **Real Capital Analytics**, New York.

Fasulo said institutional-quality assets will not flood the market at fire-sale prices as they did during the savings and loan crisis, despite falling values. He said many investors may experience disappointment with fewer opportunities than in the previous downturn.

“Much of the new supply in the market is due to corporations that have downsized or basically merged and had excess space. A lot of that space is available through the sublease market, not the direct market,” Fasulo said. “When the market does recover, that sublease space is going to be sucked back in by these companies quicker than anyone believes. You are going to find a situation where we get back to equilibrium—if not undersupply—in a very short period of time. That has the ability to tighten up the market and get these troubled assets filled with tenants again paying good rents.”

Despite guidance by the FDIC to extend income-producing property loans, unemployment remains a key factor for commercial real estate, particularly office and retail properties.

The **Mortgage Bankers Association** forecasts **10.1 percent** unemployment for this year, followed by a **9.4 percent** average in 2011 and **8.3 percent average** unemployment in 2012. Some industry analysts also said many jobs lost will not return.

"It will be a slow return, it will be a slow recovery," said **Bob Bach**, senior vice president and chief economist at **Grubb and Ellis**, Chicago. "We won't see **5 percent** unemployment--or even **6 percent**--for several years. But, the people who do have money, that do have jobs, once the labor market starts to firm up and this sense of fear recedes a little further, then we will start to see them loosen the purse strings a little bit. It's not just the people who don't have jobs that stop spending when things got really bad late in 2008, it was also people who had jobs and feared for their jobs."

Fasulo said transaction activity primarily took place in "gateway cities" at the end of 2009, and Haberman said "arms-length transactions," such as ones that took place in Washington, D.C., help establish true value and drive market confidence. He said some discounted payoffs at this time are market value because, otherwise, a lender will wait or foreclose on a property, but true value will not return until numerous transactions take place.

"Going back to the market definition, the only time that the market is going to feel that there is true value out there is when there are numerous arms-length transactions—people start transacting again on all types of properties," Haberman said. "To me, going back old school to my appraisal education, going back as a market participant, that is the only way that anybody is going to feel that there is any sort of value established out there."