

The Commercial Real Estate Outlook

1992 vs. 2009: Similarities, Differences & the Opportunities

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1. Oversupply vs. Over-leverage: How 2009 is Different From 1992

Then: 1992

In 1992, there was a commercial real estate “over supply” problem. Banks and Savings & Loans created too much new real estate. Due to the loosening of regulations on Savings & Loans, many projects were financed on spec, and were built and never occupied. In short, commercial real estate was oversupplied.

In order to correct this problem, the Federal Government became a “real estate liquidator” and called itself the RTC (Resolution Trust Corporation). The RTC quickly and aggressively shut down illiquid Savings & Loans and banks, and took control of their assets. The RTC was very effective and efficient and liquidated (sold) the excess real estate assets at what ever price the market would pay.

Now: 2009

In 2009, commercial real estate is over leveraged, not oversupplied. Too many properties (while occupied) have debt that can no longer be paid current and the underlying loans cannot be repaid at maturity. The run up of debt over the last 15 years is a more complex problem than the oversupply problem of the early 1990’s. This

is because there may be multiple lenders on a single asset, all who have different interests and agendas on how the “workout” should be handled.

2. The Perfect Storm

After 15 years of easy credit, commercial real estate is now saddled with record amounts of debt. Now the market has changed and **three key factors will alter commercial real estate finance business for the foreseeable future:**

i. The capital markets

contracted: The majority of real estate capital has left the market. Now there is very little capital available, right at the time that the massive amounts of debt originated over the last 15 years is coming due.

ii. Underwriting standards

tightened: The debt that is available has much more stringent underwriting criteria. The loans that will be approved in the future will have much lower loan amounts.

iii. Fundamentals have declined:

The economic downturn is affecting real estate fundamentals. Vacancy has increased, rents have decreased. This has caused real estate cash flows to decline.

3. The Results of the Perfect Storm

This perfect storm will have a material impact on the commercial real estate business for years to come.

Maturity defaults:

- i. There is not enough capital in the system to refinance all of the debt coming due.
- ii. The debt that can be refinanced will require equity infusions to meet the new underwriting standards.

Term defaults: Some properties can no longer service their principal and interest payments due to over leverage and declining fundamentals.

Owner’s liquidity crunch:

Owners of real estate are feeling the pain from all sides:

- i. More equity to rebalance loans (pay downs)
- ii. More equity to cover interest short falls
- iii. More equity to for property operating expenses, like tenant improvements and capital improvements

3. Lenders: Few Good Options

Lenders have only a few options when dealing with these problems:

- i. Foreclose and own the property
- ii. Sell the note at a deep discount
- iii. Extend the loan and hope that time cures the problem

5. The Federal Government’s Role

In 1992, we had an aggressive government action to close banks and liquidate their assets. Given our current economic environment, it seems unlikely that the current

administration will take similar actions.

6. The Numbers: 2010-2013

The numbers on future maturities are staggering:

Total real estate maturing between 2010-2013: \$1.415 trillion

Bank loans maturing between 2009-2013: \$1.068 trillion

Toxic CMBS loans ('05-'07 vintage) maturing between 2009-2013: \$112-187 billion

Life company loans maturing between 2009-2013: \$100 billion

The big question: Where will these loans go and what will happen to the underlying properties?

7. The Opportunity

The opportunity for those with capital is to take advantage of the

current dislocation by “providing liquidity to illiquid situations.”

There is an unlimited supply of asset rich/liquidity poor sponsors who are seeking capital to save their projects. The “smart money” will be in providing this capital and enjoying significant risk adjusted returns.

Providing this capital to real estate owners and operators will take many forms and will include debt, participating debt, preferred equity and equity opportunities. These transactions will include:

- Discounted note re-purchases
- Capital improvement financing
- T/I financing
- Partnership buyouts
- Recapitalizing maturing debt

- Short term bridge loans

In some cases there will be more traditional opportunities:

- Non-performing loan purchase
- Opportunistic asset purchases
- Non-performing loan financing

Summary

The federal government’s passive and “supportive’ approach has created a tremendous price dislocation and has caused transactions to cease. Investors can either choose to be frustrated by the bid/ask gap or can seek strategies that work in tandem with the economic and political situation. In JCR’s view, the “right answer” is to be a liquidity provider in an illiquid market.

