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Oversupply vs. overleverage: How 2009 is different from 1992

In 1992, there was a commercial real estate “oversupply” problem. Banks and savings and loans created too much new real estate. Due to the loosening of regulations on S&Ls, 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 Resolution Trust Corp. The RTC quickly and aggressively shut down illiquid S&Ls and banks, and took control of their assets. The RTC was very effective and efficient; it liquidated (sold) the excess real estate assets at whatever price the market would pay.

In 2009, commercial real estate is *overleveraged*, not oversupplied. Too many properties (while occupied) have debt that no longer can be paid 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 1990s. This is because there may be multiple lenders on a single asset, all of whom have different interests and agendas on how the “work-out” should be handled.

Assets today could have debt from one or more of the following sources: banks, commercial mortgage-backed securities, insurance companies, private finance companies and collateralized debt obligations.

The Perfect Storm

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



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■ **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.

■ **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.

■ **Fundamentals have declined.** The economic downturn is affecting real estate fundamentals. Vacancy has increased and rents have decreased. This has caused real estate cash flows to decline.

Results of Perfect Storm

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

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

■ **Term defaults.** Some properties no longer can service their principal and interest payments due to overleverage and declining fundamentals.

■ **Owner's liquidity crunch.** Owners of real estate are feeling the pain from all sides: more equity to rebalance loans (pay downs);

more equity to cover interest short falls; and more equity for property operating expenses, like tenant and capital improvements.

Lenders have only a few options when dealing with these problems: foreclose and own the property; sell the note at a deep discount; or extend the loan and hope that time cures the problem.

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.

There is a tsunami of commercial real estate debt coming due, with no place to go. This flood of maturities only will depress prices further, as there will be too many sellers/refinances and not enough capital.

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 (2005-2007 vintage) maturing between 2009-2013: \$112-187 billion; and
- Life company loans maturing between 2009-2013: \$100 billion.

Source: Deutsche Bank, Intex, Trepp, Mortgage Bankers Association, Federal Reserve

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

The Opportunity

Many people are chasing assets, hoping that there will be a flood of nonperforming or subperforming commercial assets in the market at pennies on the dollar. This will not be the case unless the federal

government gets aggressive and begins to close banks at a much faster pace.

Thus, 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; tenant improvement financing; partnership buyouts; recapitalizing maturing debt; and short-term bridge loans.

In some cases there will be more traditional opportunities: nonperforming loan purchase; opportunistic asset purchases; and nonperforming loan financing.

There will be fewer of these opportunities than many expect, and we believe that providing equity and debt to these situations will lead to better investor results than trying to purchase fee-simple assets.

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