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The future of CRE finance: limited capital supply lingers

The past: There is \$1.4 trillion of commercial real estate debt that is coming due over the next few years. This represents 40 percent of all commercial real estate debt. With values down 30 percent to 40 percent, most of these loans cannot be refinanced at par.

Now for the present.

■ **Community banks.** They are holding onto their assets because they cannot afford to sell at market prices. If they do so, they risk being insolvent. The Federal Deposit Insurance Corp. is not aggressively closing banks. It is aggressively putting banks under operating agreements so they can be watched like small children. Community banks will not be making new real estate loans anytime soon.

■ **Large regional banks.** These banks are overburdened with legacy loans and real-estate owned loans. They have been able to raise equity or have received Troubled Asset Relief Program funds, so failure is unlikely. Yet, they need to shed these bad assets, but they are taking their time. The first assets to go are those that do not pay interest (i.e., land and condos). Next are those that only pay partial interest. If the note pays current, it will be extended.

■ **Money center banks.** They typically hold larger



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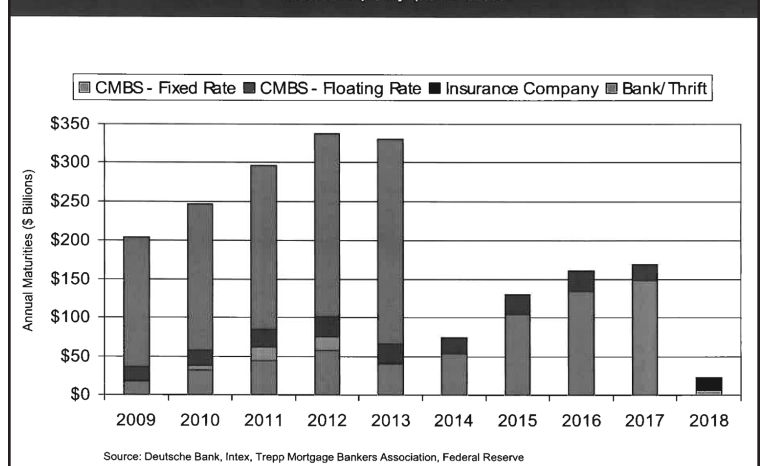
assets, and they will extend and pretend where they can. The money center banks will try to wait this out.

■ **Private lenders.** In the “go-go” credit years, private lenders were forced to do the most risky deals as securitization took away their bread-and-butter product. Thus, these lenders’ balance sheets are full of nonperforming construction loans and land loans. They will not be making new loans and will be in workout mode for quite some time.

■ **Life companies.** There is not a lot of distress in these portfolios. They will typically cure their own problems on a situational basis. These lenders are active, but very selective.

■ **CMBS.** The floodgates are opening and commercial mortgage-backed securities defaults are rising quickly. Special servicers have more problems than people to deal with them. Expect to see a continuous flow of nonperforming loans offered by CMBS special servicers.

Estimated maturity profile of commercial mortgages in CMBS, bank and life company portfolios



And now for the future.

What will the commercial real estate finance landscape look like? Here is a snapshot:

We are back to balance sheet (hold the risk) versus syndication (sell the risk). This will greatly limit the supply of capital. A limited supply of capital will continue to keep real estate values down for the foreseeable future. The following “four truths” of commercial real estate will weigh heavily on the market for years to come.

1. **Less capital available:** There will be less capital in the market going forward. The highly reliable CMBS market of \$150 billion to \$200 billion of annual liquidity is gone!

2. **More equity required by**

lenders in the market: Old model: 10 percent to 20 percent equity. New model: 30 percent to 40 percent equity.

3. **Tougher underwriting standards/assumptions** by lenders who are in the market.

4. **Declining real estate fundamentals:** Increasing vacancy and lower rates.

These “four truths” point to an extended period of slow distress for the commercial real estate market. It will take three to five years to work through the inventory of maturity and return to a level of transaction normalcy. In the meantime, those with capital, few legacy issues, and balance sheet expense, will thrive on this new paradigm.▲