Drivers WANTED!

BY JAMIE WOODWELL

As the U.S. economy works its way out of the "Great Recession" of 2007/2008/2009, commercial real estate activity—particularly property sales and mortgage originations—remains extremely low. Given the state of many of the drivers of such activity, it is unlikely the market will see a dramatic rise in activity in the coming year(s).

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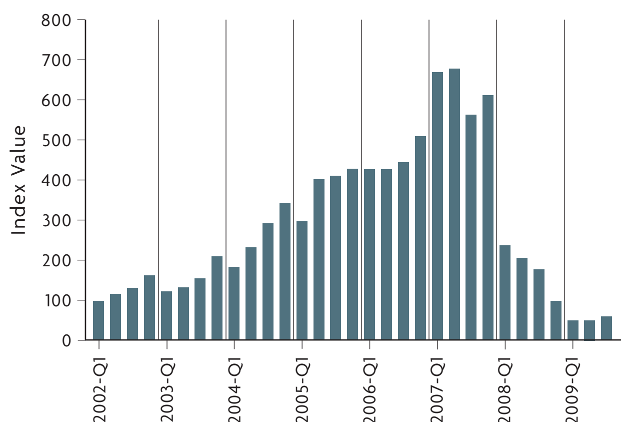
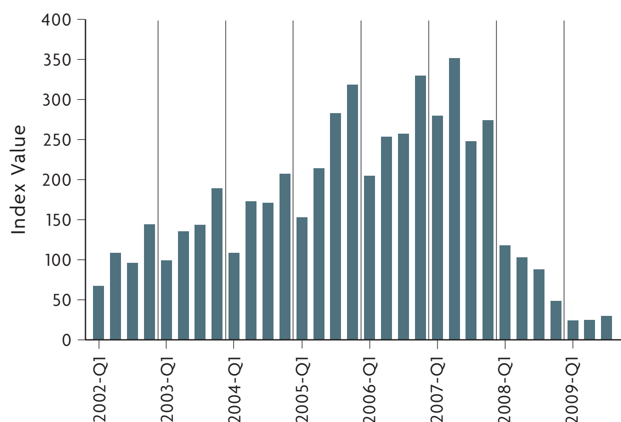
ccording to Real Capital Analytics Inc. (RCA), New York, in the first three quarters of 2009, $31 billion of apartment buildings, office buildings, retail centers and industrial properties (valued at $5 million or more) changed hands. That compares with $133 billion in the first three quarters of 2008 and $332 billion in the first three quarters of 2007, meaning third quarter year-to-date property sales in 2009 were just 9 percent of their 2007 levels (see Figure 1). ■ Commercial and multifamily mortgage originations followed a similar decline—though not quite as deep. Third-quarter year-to-date originations in 2009 were 60 percent below their 2008 levels, which were 57 percent below 2007 levels. Third-quarter year-to-date originations in 2009 were just 17 percent of the level seen in 2007 (see Figure 2). ■ The use of 2007 as a benchmark is patently unfair. As has often been noted, 2007 was an extraordinary market peak. It was the year in which Hilton Hotels Corporation, Equity Office Properties, Archstone-Smith, Reckson Associates Realty Corporation, The Mills Corporation, CNL Hotels & Resorts Inc., Crescent Real Estate Equities Co. and numerous other large portfolios changed hands and were financed. ■ Property sales, mortgage originations, property prices and a raft of other indicators all hit their peaks in 2007. Regardless of how high that peak was, however, the fact remains that the current trough of transaction activity is very, very low. ■ What's behind this paucity of transactions? While many industry observers speak of impediments to transaction activity in the current market—whether bid-ask spreads, a lack of debt availability or some other factor—the reality is that there are very few drivers of transaction activity in today's market. There is little incentive for property owners to sell, for borrowers to refinance or for lenders to force an issue that may end up resolving itself.

Figure **1** **Index of Commercial/Multifamily Property Sales Volume**
(2001 Average Quarter = 100)



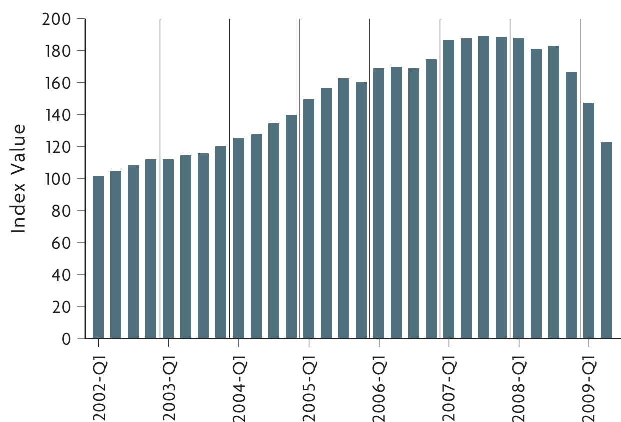
SOURCES: Real Capital Analytics, Mortgage Bankers Association (MBA)

Figure **2** **Index of Commercial/Multifamily Mortgage Bankers Origination Volumes**
(2001 Average Quarter = 100)



SOURCE: MBA

Figure **3** **Index of Commercial/Multifamily Property Prices**
(2001 Q4 = 100)



SOURCES: Moody's/REAL, MBA

Little incentive to sell

For a property sale to occur, one needs a willing buyer and seller. Given current market conditions, most existing property owners have very little incentive to sell.

Prices

During the years 2004, 2005, 2006 and 2007, commercial real estate (CRE) owners saw the values of their properties rise dramatically. According to the Moody's/REAL Commercial Property Price Index, values rose 16.3 percent during 2004, another 14.7 percent in 2005, another 8.4 percent in 2006 and an additional 8.3 percent in 2007. After just four years, the average owner saw a 57 percent increase in value, on an unlevered basis. Given that most of the properties had debt financing in place, the appreciation of the equity stake was far greater (see Figure 3).

Looking at the last two years, however, one sees the opposite effect. The Moody's/REAL data show third-quarter 2009 prices are now down more than 40 percent from their peak.

The recent data are based on a sparse number of transactions, which are likely driven by distressed sales, so their applicability to the market as a whole is uncertain. But without a doubt, the vast majority of property owners looking to sell a property today are looking at a price well below what they would have received at the peak of the market—and in many cases below what they may owe on their mortgage.

Cap Rates

Similarly, capitalization rates have been on the rise. Investors across asset classes—from corporate equities to corporate bonds to structured finance—responded to the credit crunch and recession by demanding higher yields. The same is true for investors in commercial and multifamily properties. The combination of this investor reluctance and declining property incomes has resulted in upward pressure on capitalization rates.

According to Real Capital Analytics, average cap rates in the third quarter of 2009 were up between 20 percent (for retail properties) and 33 percent (for office properties) from their 2007 lows. (Apartment cap rates, driven by the condominium-conversion boom, hit their lows two years earlier, in 2005, but have since seen a 22 percent increase—an increase roughly on par with other property types.)

Given that many existing commercial real estate owners purchased their properties at lower cap rates, anticipating lower returns, the higher yields required by new investors mean a mismatch between what the existing owner would need to receive to precipitate a sale and what the purchaser is looking for in return. As a property continues to cash flow, existing owners are likely to clip the net operating income (NOI) coupon and look to the same going-forward marked-to-market returns as would a new purchaser.

Incomes

Another key dynamic holding back commercial property transactions is the fact that commercial and multifamily properties produce income.

The recession of 2007/2008/2009 has led to a weakening of commercial property fundamentals. According to

Property & Portfolio Research Inc., Boston, average rents are down and vacancy rates are up across all major property types. For almost every property type, vacancy rates are at levels higher than those seen in the early 1990s.

But the lease structures of commercial properties—particularly office and retail properties—mute many of the impacts of the recession. Revenues are based on leases that generally have staggered roll dates, meaning that for most property types, most leases carry forward through a recession. The result is that many commercial properties are seeing declining revenues, but the declines are not as steep as what has been seen in other parts of the economy.

That income, even when reduced by increased vacancies or more concessions to tenants, means that most properties continue to 1) meet their debt obligations and 2) throw off additional income for the owners. Rather than sell a property at what might be a loss and at what is likely the trough of the market, the incomes enable property owners to hold on to their investments and to try to ride out the cycle.

Little incentive to refinance

In addition to the lack of incentives to sell properties, there are presently relatively few drivers pushing existing owners to refinance a property.

Rates

One of the greatest incentives to refinance in the current environment has been the extremely low base interest rates. At the beginning of December 2009, 10-year Treasury rates were hovering around 3.25 percent—rates that, except earlier in 2009, had not been seen since the 1950s. Even when risk spreads are stacked on top of such low base rates, the all-in mortgage rate is historically very, very attractive (see Figure 4).

But the differential between current rates and rates in place on existing mortgages may not be great enough to drive any significant level of refinancings.

The slim investor spreads that were placed on mortgages originated in 2005, 2006 and 2007, coupled with relatively low base rates during the period, made borrowing extremely cheap. According to JP Morgan Securities Inc., New York, the average coupon rate on fixed-rate commercial mortgage-backed securities (CMBS) conduit loans currently outstanding is 6.54 percent. The rates on outstanding CMBS loans originated in 2005, 2006 and 2007 are 5.39 percent, 6.01 percent and 6.05 percent, respectively.

By contrast, CMBS conduit loans originated in 2000, many of which will be maturing in 2010, have an average mortgage coupon rate of 8.36 percent. For recent loans, today's rates provide little impetus to refinance an un-matured loan. And while refinancing older mortgages can lower the debt service, other market conditions are likely to deter most of the optional refinancing activity.

Proceeds

During the boom years of 2005, 2006 and 2007, many property owners took advantage of market conditions to refinance their properties and extract some of the accrued equity. As mentioned earlier, property prices had risen dramatically and lending terms were extremely competitive. Rather than sell a property, many owners chose to take cash out by refinancing.

At present, with property values down, property fundamentals weakened and lending terms tightened, lenders are generally looking for additional equity to be put into, rather than taken out of, commercial and multifamily properties. As a result, a major driver of originations in the boom years—proceeds—is generally sidelined for now.

Terms

The underwriting terms in the current market are an additional disincentive to refinance at present. With uncertainty about property values and performance, lenders are bringing a conservative eye to new loans. Loan amounts will often be predicated on current market values (hard as they may be to deduce, given the low volume of sales), and rents, vacancies and other underwriting assumptions will incorporate the effects of the worst recession since the Great Depression.

Add to that tighter acceptable loan-to-value (LTV) ratios, and a commercial mortgage made today is far more restrictive than what might have been seen at the top of the market. When comparing a mortgage one could get today to one that might be in place, most borrowers are likely content to stick with what they have.

Little incentive to foreclose

There has also been talk of a wave of foreclosures as a driver of activity. But like owners, lenders have few incentives or opportunities to drive transactions—particularly through foreclosure. The vast majority of mortgage borrowers continue to make their payments, and even among those who encounter difficulty, it is often current market conditions that are at issue—not the borrower or the loan.

In response, lenders often decide that working with the existing operator is the wisest course of action. Regulators seem to agree. Recent guidance from the Federal Deposit Insurance Corporation (FDIC) and others has signaled an appreciation for, and support of, lenders' decisions to let loans work through the cycle, rather than to force a foreclosure

Figure **4** **Market Yield on U.S. Treasury Securities at 10-year Constant Maturity**

SOURCE: FEDERAL RESERVE BOARD

when other options may be preferable.

Delinquencies

The depth and length of the 2007/2008/2009 recession have placed considerable strains on commercial and multifamily mortgages. And while delinquency rates have climbed among all investor groups, the performance of commercial and multifamily mortgages has actually been "less bad" than most other types of loans.

According to data from the FDIC, as of the third quarter of 2009, the percent of commercial and multifamily mortgage balances held by FDIC-insured institutions that were 90-plus-days delinquent or in nonaccrual—3.40 and 3.58 percent, respectively, and up from 1.36 and 1.47 percent a year earlier—are a fraction of the equivalent delinquency rates for construction loans (15 percent, up from 7.3 percent) and single-family mortgages (8.06 percent, up from 3.64 percent). They are actually in line with the delinquencies on other commercial and industrial loans (3.56 percent, up from 1.01 percent). Charge-off rates for commercial and multifamily mortgages (0.62 percent and 0.92 percent) were the lowest of any types of loans held by banks and thrifts (see Figure 5).

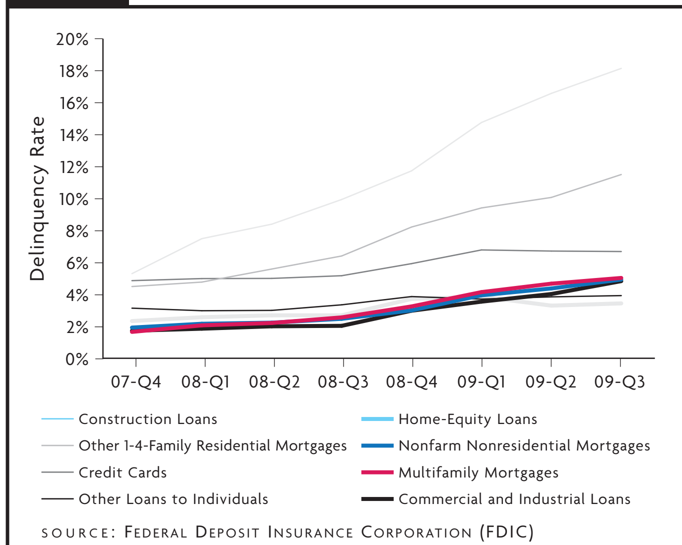
Commercial and multifamily mortgages are feeling stress. But given that they continue to produce income, even when foreclosed upon, and that there is real collateral backing up the loan, lenders are in a far stronger position with income-producing properties than they are with most other loan types.

Regulators

Regulators appear to agree. On Oct. 30, 2009, federal regulators including the Board of Governors of the Federal Reserve System (FRB), the FDIC, the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee released guidance on "Prudent Commercial Real Estate Loan Workouts."

The guidance outlines the conditions in which the regulators will and will not penalize banks and thrifts for working out commercial loans and states, "while CRE borrowers may experience deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work constructively together."

Figure 5 Banks and Thrifts: 30-Plus-Day Delinquency Rates of Loans and Leases



SOURCE: FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Few maturities forcing issues

At the onset of the current credit crunch and recession, many observers raised concerns that 2009 would see a wave of mortgage maturities for which no financing would be available. In February 2009, the Mortgage Bankers Association (MBA) released the results of a detailed analysis of loan maturities, based on data coming directly from commercial/multifamily servicers. The results show that such concerns were largely misdirected.

Unlike commercial paper, consumer debt and many other forms of lending that have short-term maturities, commercial and multifamily mortgage maturities are longer-term in nature and are generally spread out over a 10-year period. In addition, a disproportionate share of loans were made in 2005, 2006 and 2007, meaning that the bulk of the mortgages for "institutional" commercial/multifamily properties will not be coming due until 2015, 2016 and 2017.

In fact, rather than being a driver of sales, origination and foreclosure activity, at present the maturity schedule of commercial and multifamily mortgages is acting as a drag on such activity. Were maturities evenly spaced over a 10-year period, 20 percent would be coming due over any two years. The 2008 survey found that one in five dollars (20 percent) of outstanding CMBS loans would be coming due in 2009 and 2010, as would just 13 percent of the loan balance held by life insurance companies and 10 percent of the loan balance held by Fannie Mae, Freddie Mac and Ginnie Mae.

There are no solid numbers for the holdings of banks and thrifts, but it is likely that to match their liabilities, a greater share of their loans is shorter-term in nature, which may prompt increased transaction activity among these loans and properties in the coming year. (MBA will be releasing updated numbers on loan maturity volumes in early February.)

Bought and held

With so few drivers of transaction activity in the current market, most property owners are now in a "bought-and-held" mode. They will be looking to properties' incomes to provide a return on their investment while they await a rebound in property valuations. As some level of "normalcy" begins to return to the market—at whatever pricing, operational and underwriting levels that might entail—disincentives to transaction activity will continue to fall away. It will likely be some time, however, before we see drivers of such activity return in force. **MB**

Jamie Woodwell is vice president of commercial real estate research for the Mortgage Bankers Association (MBA) in Washington, D.C. He can be reached at jwoodwell@mortgagebankers.org.