

## Wary of Realizing Losses, Lenders "Pretend and Extend"

By Elaine Misonzhnik with Retail Traffic, July 14, 2009

RETAILTRAFFIC

Two new phrases have entered the commercial real estate industry lexicon in recent months: "Pretend and extend" and "A rolling loan gathers no loss." Both witticisms describe an ongoing phenomenon in commercial real estate finance: as the level of distress mounts, lenders have been loath to seize properties from troubled borrowers.

Instead, in many cases banks are generously granting extensions or other modifications even in situations where it appears unlikely that borrowers will be able to pay back the loans.

Year-to-date, \$60.5 billion in commercial real estate assets have entered default or delinquency, according to a recent report from Real Capital Analytics (RCA), a New York City-based research firm. (Overall, the firm counts \$108 billion of assets in default, foreclosure and bankruptcy, including some 1,420 retail assets worth \$31.1 billion.) In contrast, only \$4.1 billion in troubled asset situations have been resolved this year. As one indication of this trend, from January through April, the 20 largest banks in the country reported that modifications of existing loans outnumbered new commitments by approximately two to one, notes Sam Chandan, president and chief economist with Real Estate Econometrics, another New York City-based real estate research firm.

What's at work is that lenders are attempting to avoid recognizing writedowns and losses on their commercial real estate loan books. Loans originated at the height of the market were done at near 100 percent loan-to-value ratios and underwritten with generous assumptions on increasing occupancies and rents. But in the past two years commercial real estate values have dropped considerably and fundamentals have weakened. Rents and occupancies are now dropping quickly, not rising. On top of everything, a major source of financing, the commercial mortgage-backed securities (CMBS) market, remains locked down.

Many banks hope that if they stave off foreclosure for a year or two, even if a distressed sale becomes inevitable, they will be able to recover more of their investment than they would if they sold right now. In the case of multi-family or office buildings, that might turn out to be the case, according to Christopher Grey, managing partner with Third Wave Partners, LLC, an El Segundo, Calif.-based advisory firm. But the likelihood of a significant increase in the value of retail properties, in his estimation, remains low.

"The reason is not only do you have extremely negative fundamentals, there's a tremendous overhang of properties that are distressed and very little investor interest," Grey notes. "Retail is tied to the consumer, which is in a position of long-term damage. People are going to expect income declines [for the foreseeable future], so they will want a very high cap rate."

So lenders are playing a waiting game. Foreclosing on assets today

means they would have to manage properties in a treacherous economic climate. The alternative would be to sell. But the investment sales scene is not encouraging. Distressed assets are trading at steep discounts to peak market prices, says Gerard V. Mason, executive managing director with Savills US, a New York City-based real estate services provider that is currently involved in up to five off-market extension transactions. If banks were to take back these assets now and try to sell them, they would fetch prices as much as 35 percent off pricing peaks. In May, the most recent month for which data is available, only \$418 million in retail properties changed hands, representing a 12 percent decline in sales activity compared to April and a decline of 89 percent compared to May of 2007, the peak period for the investment sales market. That's because with owners not facing imminent foreclosure, the bid/ask gap remains wide. In May, asking cap rates on retail properties averaged 7.75 percent, according to RCA statistics. In reality, however, well-located retail centers should now trade in the 11 percent to 12 percent cap rate range.

"Sellers are hanging on and hoping that things will get better, but for the most part, they have loans that have loan-to-value ratios of over 100 percent," says Dan Gorczycki, managing director with Savills. "Prices are still artificially high because there are no sales. It's clearly bad [for the market] because all the people that did raise acquisition funds are just waiting and waiting and waiting."

Instead, what has played out meshes with what many observers predicted in October when they expected that as defaults rose, lenders' first instinct would be to grant extensions and rework loan terms rather than foreclose on troubled assets.

The question today is how long can this delicate balance hold? In the long term some market observers worry this strategy, employed on a wide scale, might delay the process of price discovery, prolong the freeze in the investment sales market and negatively impact the cash flows for individual properties as they remain in the hands of owners unmotivated to increase their value.

The endless extensions granted to retail giants Centro Properties Group and General Growth Properties as they struggled with unmanageable debt maturities for much of last year are the most vivid examples of lenders' unwillingness to take back commercial property. For example, after months of winning extensions and forbearance agreements from some of its creditors, in late March, General Growth failed to win a reprieve from some of its bondholders. Under normal circumstances, the volume of past-due debt it was carrying would have forced it immediately into Chapter 11 bankruptcy. Instead, General Growth hung on for two weeks before finally filing.

But the trend has been happening on a smaller scale as well. In the case of CMBS loans, special servicers have their hands tied by regulations

surrounding CMBS collateral pools. Even if an asset in such a pool falls back on its mortgage payments, the servicer can't extinguish the loan, says Kristin Mueller, executive vice president of business development and leader of the receivership group with Jones Lang LaSalle Retail, an Atlanta-based third party property manager. As a result, instead of foreclosing, the servicers are increasingly turning to receivers to take over the management of such properties and eventually attempt to sell them (a sale outside foreclosure also allows the lender to provide seller financing, rather than looking for an all-cash buyer, Mueller notes.) Meanwhile, banks and other traditional lenders want time to develop a long-term strategy for their real estate portfolios, as well as being reluctant to sell at the bottom of the market.

Lenders are not treating all borrowers equally, however. They are making distinctions based on the quality of borrowers and assets. In cases where properties boast healthy cash flows and owners with proven track records, lenders see little reason to foreclose, notes Dan Fasulo, managing director with RCA. Why go through the tumult of a foreclosure and changing over day-to-day property management if the current management team is doing a good job? In these cases, the delinquencies are more the result of the poor financial climate than they are of mismanagement.

On the flip side, on properties left in the hands of owners who hold little to no equity in them, cash flows might erode further. Managing a successful retail center takes money, starting from leasing commissions and ending with tenant improvement dollars, and a financially strapped owner won't have the resources necessary to maintain occupancy levels, Grey says. He, as well as a few other market observers, hopes the current logjam will start to un-wind by the first quarter of 2010. If their predictions are on target, it will be another three to five years before all the bad commercial loans out there get resolved. But if lenders continue to postpone dealing with troubled assets, the resolution of this crisis might take as long as 10 years.

"If we go through what we went through in Japan, it will obviously be a lot longer," Grey says.

The good news is that in many cases, lenders are not simply extending the loans - they are trying to rework the terms in such a way that they don't have to come back to the negotiating table six months or a year down the road. They are factoring in falling cash flows and the possibility of higher vacancies and lower rents, says Chandan. The bad news is that in a number of instances, banks may not be lowering those assumptions enough. Meanwhile, with banks unwilling to take troubled assets to market, opportunistic investors continue to stay away from acquisitions and the process of price discovery in commercial real estate continues to be arduous.

SOUTHEAST TEXAS

## Office Building Transactions Remain Stable in Houston

Marcus & Millichap

HOUSTON, July 16, 2009 - Houston was the last major metro to enter the recession, which should mitigate the effects of job losses on the office market for much of this year, according to a second-quarter Office Research Report by Marcus & Millichap, the nation's largest real estate investment services firm. The metro traditionally is late to economic booms and recessions, which helped to sustain employment growth in 2008.

"Office investment opportunities are prevalent in Houston, which should keep deal flow healthier than the national average and support a significantly lower price correction," says Brent Smith, regional manager of the Houston office of Marcus & Millichap.

### Following are some of the most significant aspects of the Houston Office Research Report:

- Companies in Houston are expected to cut payrolls by 55,000 positions this year, a 2.1 percent decline in overall employment. Office-using head counts are projected to decline by 5.6 percent, or 31,400 workers.

- Construction in the metro is accelerating to 3.7 million square feet this year, compared with 3.4 million square feet in 2008. Despite the increase, the number of new projects that break ground in the second half of the year is expected to decline as construction loans evaporate.

- As the local economy weakens, office vacancy is projected to finish 2009 at 14.9 percent, a 220 basis point rise from year-end 2008 and the highest rate since mid-2006.

- Although rent growth in Houston has been the strongest in the country over the past year, job losses are beginning to weigh on the sector. As a result, asking rents are forecast to slip to \$23.31 per square foot by year end while effective rents retreat to \$19.81 per square foot, annual declines of 3.1 percent and 4.1 percent, respectively.