

The Credit Crisis in Commercial Real Estate

Christopher Longinetti, Senior Vice President, ScanlanKemperBard Companies



It is very difficult to argue with the premise that the current financial turmoil is without modern comparison, or that its impact will be anything less than generational in its severity. The current lack of commercial real estate (CRE) financing is a tremendous challenge confronting both owners and investors and has significant ramifications with respect to underlying property valuations. However, at its core the credit crisis is a lending crisis and as such it does share common elements with past banking failures. While financial markets are experiencing unprecedented disruption, it seems negligent to ignore these commonalities, particularly when trying to understand the impacts on commercial real estate and why the worst may very well be yet to come for this market. The more challenging aspect may be in understanding just how severe it can get for the commercial real estate market as the many underlying causes and fundamental challenges ahead are truly without peer as the market attempts to restore some measure of liquidity.

The Savings & Loan Crisis

The last lending crisis with significant implications to the commercial real estate market was the savings and loan crisis [S&L] of the 1980s. From 1986 to 1995, over 1,600 FDIC-insured institutions were either closed or received federal assistance. Over 1,000 of these institutions

with assets of \$500 billion failed. The cost of the S&L crisis is estimated to have totaled approximately \$160 billion, of which about \$125 billion was directly paid for by US taxpayers.¹ That lending crisis, the recession which accompanied it, and in particular the actions of the Resolution Trust Corporation (RTC), chartered with the directive to liquidate the assets of these failed institutions, defined the commercial real estate industry during the late 1980s and into the early 1990s.

In a 1997 examination of the S&L crisis, the FDIC's Division of Research and Statistics identified four common elements of recessions associated in large part from bank failures. These common elements were:

1. Recession followed a period of rapid expansion with external factors exacerbating cyclical forces.
2. Speculative activity was prevalent and opinion, rather than fact, supported optimistic expectations.
3. Wide swings in real estate activity contributed to the severity of the recession; and
4. Boom and bust activity in commercial real estate markets was one of the main causes of losses at both failed and surviving banks.²

The first three elements are obvious in their relevance to the current financial crisis. However, the parallels to current residential markets are unmistakable. For market participants, these factors most certainly apply as well to the commercial real estate market of 2005 - 2007 which makes the fourth element particularly alarming. By and large, banks have not yet experienced significant losses with respect to their commercial real estate loan portfolios, although the market almost unanimously agrees that these losses are coming and that they will likely be sizeable.

The Credit Cycle

Underlying the business cycle is the credit cycle. Ready access to affordable capital spurs investment and fuels expansion. These periods of liquidity generally lead to periods of excess liquidity followed by contraction and relative drought as the cycle turns downward. Periods where credit flows easily can just as quickly end in periods of excessive tightening before returning to more sensible loan underwriting standards. Where the current crisis deviates from history most profoundly, particularly with respect to CRE lending, is the sheer magnitude of this most recent credit cycle, first on the way up and now in its relentless down cycle.

In understanding this credit cycle, it is important to understand the process by which financial institutions extend credit and, for the purposes of this analysis, the focus is specifically on the process by which financial institutions extend credit to the owners of commercial real estate. Within lending institutions, this process is referred to as loan underwriting and encompasses the quantitative and qualitative assessment of relative risk.

Debt is a fixed return vehicle which receives scheduled payments of interest and principal. As a result, when assessing risk from the lender's perspective, considerable attention is paid to downside underwriting: How much can the asset underperform and still produce the underwritten return? This is a significantly different perspective than that of the equity investor seeking the loan. Investment upside, property performance exceeding expectations, accumulates to the equity interest as the property owner. Better than anticipated property performance for the lender, other than providing for a greater measure of loan safety, does not provide the windfall returns that accrue to the equity holdings. The lender still receives only

¹ Source: FDIC, The S&L Crisis: A Chrono-Bibliography

² Source: FDIC, History of the 80s: Volume I: An Examination of the Banking Crises of the 1980s and Early 1990s

the scheduled payments of interest and principal, unless the lender has been granted participating income or equity kickers.

Risk Considerations

This perspective is particularly evident when discussing the standard risk considerations of commercial real estate loan underwriting which involve loan-to-value ratios, debt service coverage ratios, credit support and loan covenants as outlined in the table which follows.

Risk Consideration	Definition
Loan-to-Value Ratio (LTV)	Total Loan Amount ÷ Total Property Value
Debt Service Coverage Ratio (DSCR)	Net Operating Income (NOI) ÷ Interest and Principal Payments (Debt Service)
Credit Support	Additional Collateral or Borrower Guaranties
Loan Covenants	Ongoing Loan Conditions (e.g. minimum levels or cash flow or maximum levels of leverage)

Beyond the standard analysis of the property attributes (age, appearance, local market factors, location, etc.) these considerations define a relative risk tolerance for any loan by framing (1) the lender’s exposure within the context of fair market value, (2) the cash flow available for the payment of debt service, (3) a borrower’s ability to repay the obligation, and (4) the lender’s ability to safeguard its loan.

Conservative Loan Underwriting Standards

Immediately following the S&L crisis, CRE lending was governed by a strict adherence to conservative loan underwriting standards characterized by modest LTV ratios, strong DSCR, personal borrower guaranties and a rigorous structure providing for regular loan performance tests. However, beginning in the mid-1990s, the commercial real estate embarked on what would end up being twelve consecutive years of market growth and value increases. During that period, diligent underwriting encountered a record CRE up-cycle. Conscientious lending standards combined with stellar performance of the underlying real estate and provided for record low default rates in loans secured by commercial properties.

In turn, CRE loans established a solid track record of strong returns on investment and appealing risk-adjusted returns. Market participants increased their allocations to CRE-backed assets. Others expanded their investment portfolios then to include investment in CRE loans, attracted by greater income and capital protection than that provided by riskier equity investments. This emergence of a viable investment market for CRE loans, and the seemingly limitless demand which followed, promoted further investment and unprecedented liquidity for commercial property acquisitions. The secondary lending market, as the primary vehicle for these investors seeking to put money to work in commercial real estate, changed the nature of CRE investment in a relatively brief time period.

The secondary lending market, or securitized lending, refers specifically to loans originated and sold, or syndicated, to secondary market participants. Across all real estate lending platforms, this securitization process converts originated whole loans to mortgage-backed securities (MBS) and, specifically for commercial properties, to commercial mortgage-backed securities (CMBS). The dynamics of this market differ greatly from the more traditional commercial real estate lending model, which is referred to as the primary lending market or balance sheet lending.

In its simplest form, the primary lending market can be thought of as a local bank providing a loan for a local property to a neighborhood operator or long-time client. The market relies on relationship lending, as the originating bank or institution will be holding the loan in its

portfolio for the life of the investment. In doing so, the lending institution genuinely becomes a partner with the borrower until loan maturity.

Securitized Lending Process

By way of contrast, the securitized lending process relies upon a third party intermediary to aggregate multiple loans and resell a collection of asset pools as individual new securities. An originator is responsible for the initial underwriting and funding of the loan. The originator sells the loan to a third party intermediary, typically an investment bank, referred to as the issuer, who would be responsible for assembling the pools of loans into the CMBS security, which are then sold in the market to individual investors (see figure 1).³ The growth of the CMBS market, and its resulting impact on CRE lending, cannot be understated. The CMBS market, which first emerged in the mid-1990s, rapidly transformed real lending from one centered on local primary lending institutions to a global investment market where investors worldwide could pool funds to lend.

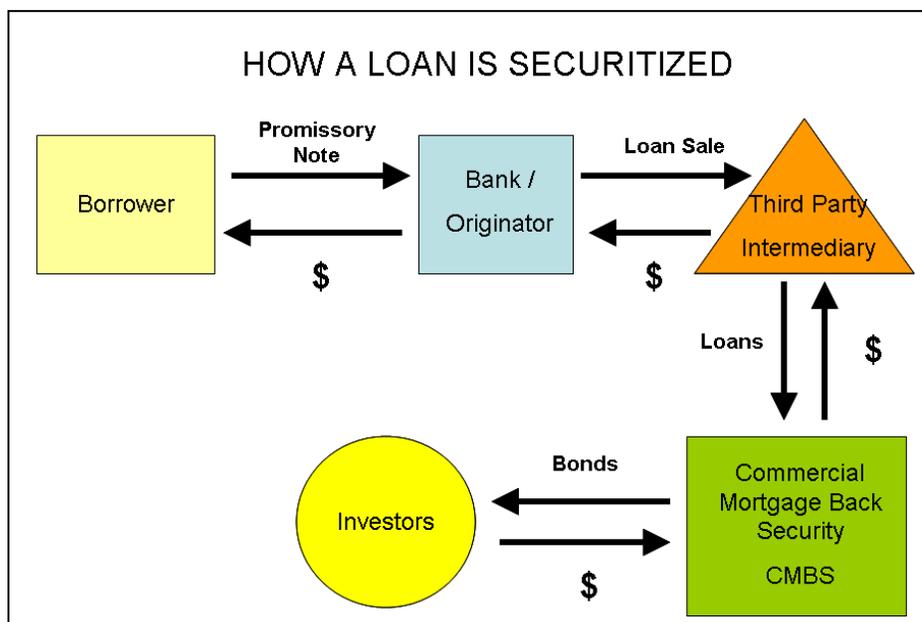


Figure 1 – Source: Federal Reserve Bank of Chicago

The growth the CMBS market corresponded with, and in large part fueled, the growth of CRE lending in general. In 1995, there were \$1.0 trillion in outstanding CRE loans of which 5.4% were CMBS.⁴ By early 2001, the CMBS market supplanted insurance companies and pension funds as the largest holders of CRE debt behind banks.⁵ CMBS issuance swiftly increased as the market demonstrated strong performance and rapidly decreased delinquencies (See figure 2). By 2005, CRE loans outstanding totaled \$2.62 trillion and CMBS represented 37% of the market. At the market peak in 2007, roughly half of the new CRE debt originations were intended for the CMBS market, which had a tremendous impact on liquidity and pricing in the commercial real estate market, as will be demonstrated later in this discussion.

³ Source: Federal Reserve Bank of Chicago

⁴ Source: Commercial Mortgage Alert, Wachovia Securities and Mortgage Bankers Association

⁵ Source: Nichols, Joseph; CMBS World, Summer 2007.

CRE lending was seen as providing an appealing risk-weighted return and CMBS were the primary investment vehicle for those outside the primary lending market.

CMBS Default Rate

As illustrated in figure 2, the CMBS default rate had historically averaged approximately 5.0%. However, in the periods that followed, delinquencies began declining rapidly, eventually falling to a record low 0.28% at the end of 2007.⁶ Loan terms began loosening and underwriting standards eased dramatically. Institutions took larger risks, compounded by the reduction of risk-mitigating covenants and structure.

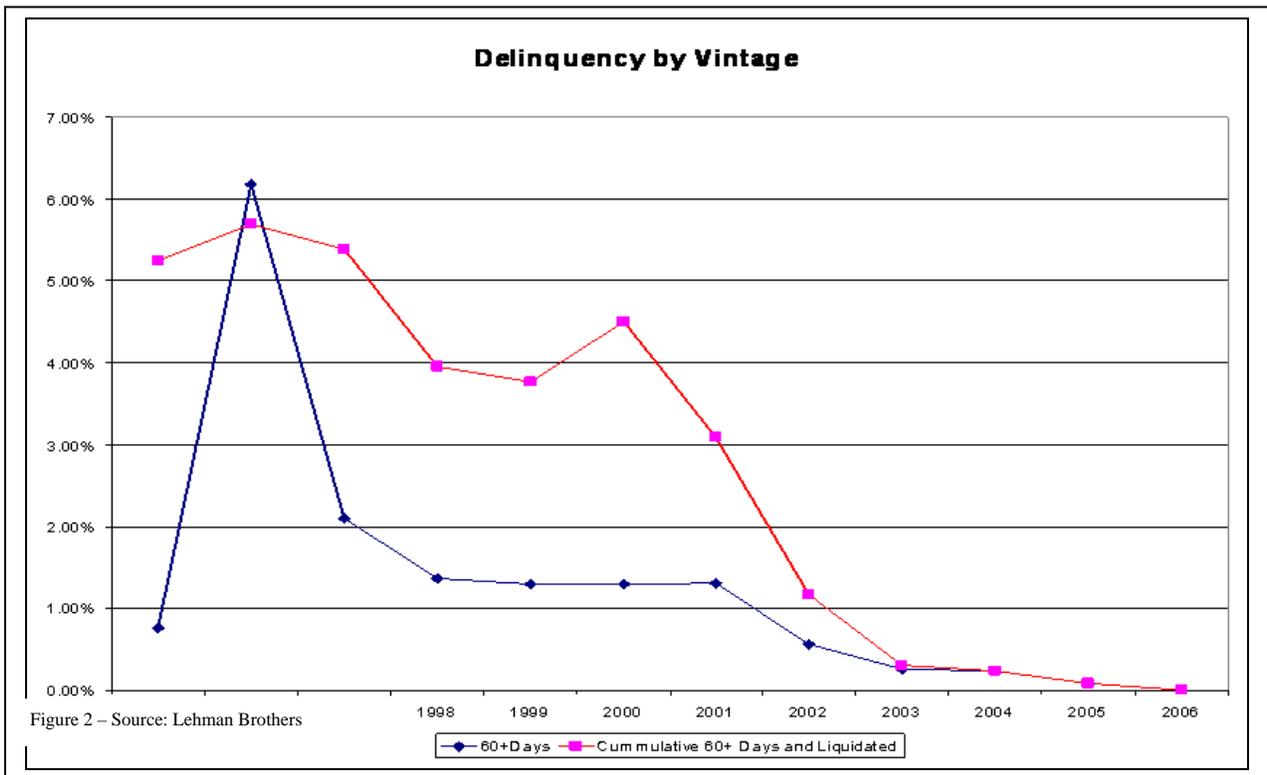


Figure 2 – Source: Lehman Brothers

This easing of credit and the ongoing bull-run of the CRE market, spurred unprecedented investment in commercial properties and demand for CRE loans. In 1988, total commercial mortgage debt outstanding was approximately \$1.0 trillion. Over the next ten years, total commercial debt outstanding had expanded to approximately \$1.2 trillion, representing a modest market growth rate of approximately 1.5% per year.

The decade which followed experienced much more rapid growth. By 2008, the U.S. market had \$3.4 trillion in commercial debt supporting \$6.5 trillion in investment-grade, income-producing real estate. From 1998 to 2008, the commercial mortgage debt market had experienced annual compounded growth of almost 11 %.

⁶ Source: Business Wire, January 17, 2008

Commercial Mortgage Debt Outstanding by Source of Funds

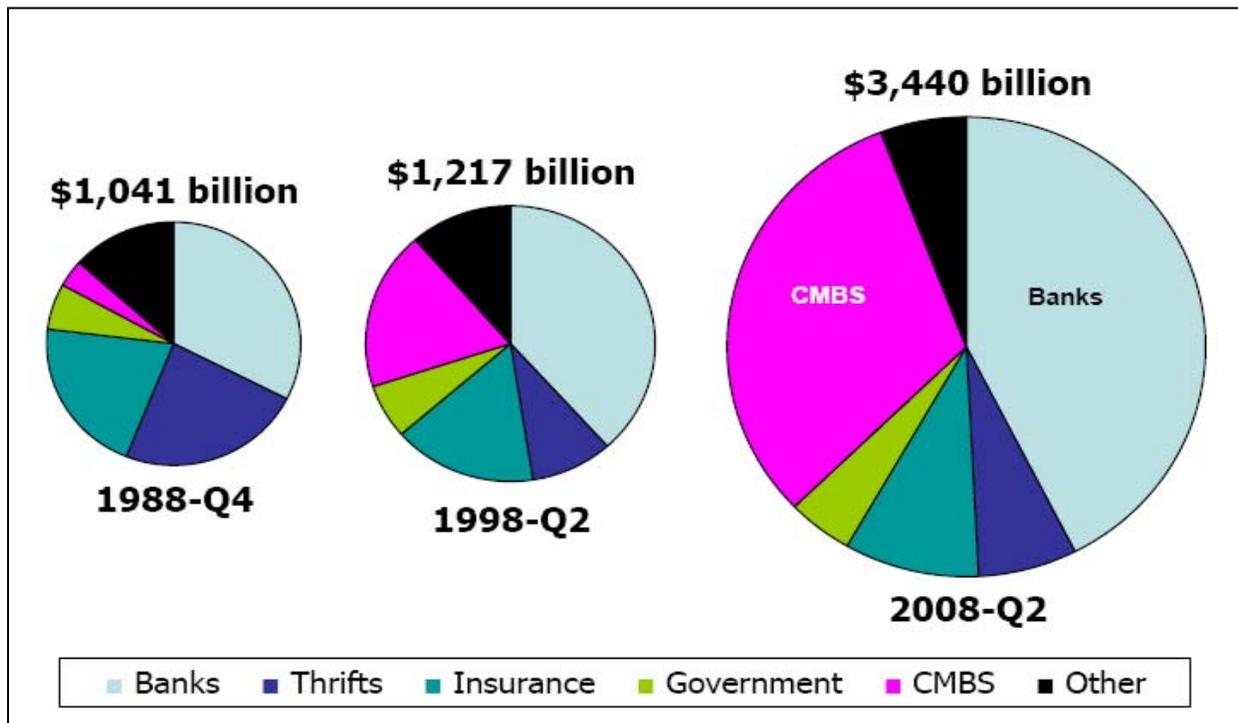


Figure 3 - Source: Federal Reserve Flow of Funds Accounts

Interestingly, depository institutions were not necessarily crowded-out by the CMBS market and maintained a relatively stable proportion of the overall marketplace. However, the securitized market was leading the way and, in doing so, began to deviate significantly from the lending standards that had been established by the primary lending community. The securitized market had effectively removed the originator as an investment companion of the borrower. The originator and the third-party intermediary securitizing the loan were often the same group. Loans originated and packaged to secondary market participants carried with them no vested interest beyond what could ultimately be sold to the market.

Credit Rating Agencies

In turn, the market relied almost exclusively on the credit monitoring by the major credit rating agencies, hired by, and on behalf of, the third-party intermediaries to assess the underlying risk. Loan originators increased maximum leverage ratios, replaced amortizing loans with interest-only ones, and in general began lending more aggressively on more volatile assets such as land and other non-cash flowing investments. In turn, these loans were packaged and sold to the investors of CMBS who, by now, were more than comfortable with the safety of these investments given demonstrated past performance, AAA-credit agency ratings, and a track record of decreasing delinquencies. This is particularly true of loans originated in 2006 and 2007, which are generally considered the worst of the CMBS vintages.

Depository institutions generally followed suit. In order to compete with the secondary market, underwriting standards loosened. Additionally, small to mid-size institutions increased their exposure and concentration to commercial real estate, encouraged by the performance of their

outstanding loan portfolios and low delinquencies.⁷ Market participants began to talk of fundamental changes in the commercial real estate markets. Cap rates' compression was fueled by suggestions that the liquidity premium had been eliminated from the market, given readily available capital for investment. Particularly in the office sector, market participants pointed to the relative lack of new construction as the practicing of a new market discipline that would temper the traditionally cyclical nature of commercial real estate. "This time it's different" was an expression of the collective market consensus and the only thing better than today were the prospects of tomorrow.

Commercial Real Estate Market Peak

In hindsight, with a tremendous amount of money pouring into commercial real estate, and no shortage of available financing, it was only a matter of time before the market overheated. CRE transaction volume increased 233% from \$118 billion in 2003, to \$276 billion in 2005. In 2007, investors channeled a record \$417 billion into commercial real estate in the United States, financed in part by \$233 billion in CMBS.⁸

The market peak did come in early 2007 with the sale of the Equity Office Properties Trust (EOP) portfolio to the Blackstone Group. Blackstone paid \$39 billion for 573 properties that EOP had amassed over its thirty-year history to consummate the largest private equity deal in history.⁹ Blackstone, in turn, then sold almost 70% of the portfolio within six weeks for \$27 billion to 16 different companies. The transactions broke sales volume and cost-per-square foot records in major markets throughout the country, including locally where San Francisco-based Shorenstein Properties purchased 4.0 million square feet of Portland office properties for approximately \$1.2 billion, roughly \$300 per square foot. In most cases, buyers financed the portfolio purchases aggressively, but none more aggressive than New York investor Harry Macklowe's purchase of the 6.5 million square feet of New York City properties he purchased from Blackstone for \$7.5 billion, or \$1,100 per square foot. The entire purchase was financed with short-term debt and only \$50 million of cash contributed by Macklowe. Essentially, the entire \$7.5 billion purchase was 100% financed through Deutsche Bank and the Fortress Group. Deutsche Bank would later sell some of these buildings, recouped through foreclosure, for \$818 per square foot, or almost 26% less than Macklowe's purchase less than 18 months prior.

In summer of 2007 the subprime mortgage crisis irrevocably changed the financing landscape for commercial real estate. Even though the roots of the crisis were in residential real estate lending practices, the ubiquity of the exposure across most classes of investors was surprising, most of all to investors who were unaware of any such exposure. As described by David Leonhardt in the *New York Times*, "The American home seemed like such a sure bet that a huge portion of the global financial system ended up owning a piece of it."¹⁰ However most were unaware of the underlying risk of their investments. The secondary market had become so complicated that investors relied almost exclusively on the rating agencies' evaluation of risk. When massive losses exposed the enormous flaws in relying upon these agencies, the market immediately looked to the CMBS market that functioned under much of the same investment principles. Investors lost complete confidence in the secondary market and liquidity literally vanished almost overnight. The CMBS market, which had provided \$605 Billion in commercial real estate financing in the three years prior to 2008, seized. Total CMBS market activity plummeted to \$12 billion in total issuance in 2008 with no activity at all in the second half of the year (see figure 4).

⁷ Source: CMBS World, Summer 2007

⁸ Source: NAREIT

⁹ Source: Sam Zell's Empire, Underwater in a Big Way: *NYTimes* February 7, 2009

¹⁰ Source: Can't Grasp Credit Crisis? Join the Club: *NYTimes* March 19, 2008

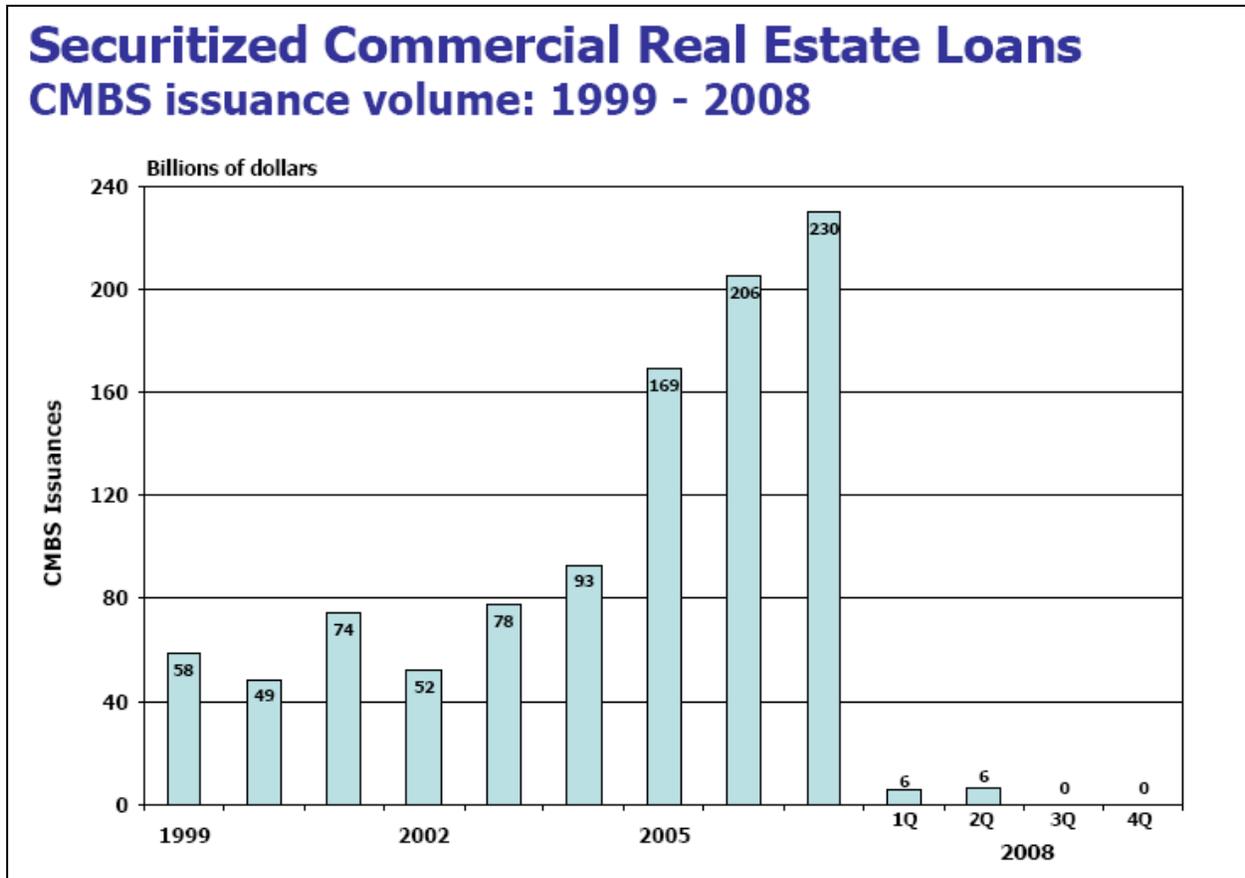


Figure 4 – Source: Commercial Mortgage Alert

As noted, the valuation of the New York City portfolio formerly owned by EOP and later acquired by Macklowe had lost almost 26% of its value in 18 months. To state that Macklowe dramatically miscalculated value oversimplifies the issue. In fact, it can be demonstrated that the change in the lending climate alone can be held responsible for a great deal of the revaluation and with it a corresponding change in market capitalization rates.

Impact of Leverage

This demonstration was initially presented in a 2009 CMBS market forecast prepared by Merrill Lynch (See Figure 5). An investor who requires a 10% return on equity (ROE) is presented with the opportunity to purchase a property with an NOI of \$6.6 million. The financing market is prepared to provide an 80% LTV interest-only loan at the rate of 5.75%. Given this available financing, the resulting cash flow after debt service would equate to a 10% return on the initial investment equity of \$20 million and the investor would be prepared to purchase the property for \$100 million equating to a 6.6% cap rate. This fairly simple example is surprising accurate in representing the commercial real estate market dynamics from 2005 - 2007.

Transfer this example with the same property and the same investor return requirements to 2009 and the effects of the change in the lending markets upon property valuation are evident. The assumption for the financing available in today's market is 60% LTV payable at 7.25%

interest and amortizing on a 30-year schedule. Given the financing now available and the resulting cash flow after debt service that would equate to a 10% return on investment, the investor is no longer able to purchase the property at any price greater than \$74 million. With no change other than the financing terms available to the investor, the property has lost 26% of its value and the market capitalization rate has increased 230 basis points.

The Impact of Leverage on Value

	2007 Loan	2009 Loan	2009 Value
Building Cost	100,000,000	100,000,000	74,000,000
NOI	6,600,000	6,600,000	6,600,000
Cap Rate	6.6%	6.6%	8.9%
LTV	80.0%	60.0%	60.0%
Loan Amount	80,000,000	60,000,000	44,400,000
Loan Type	5.75% IO	7.25% Amortizing	7.25% Amortizing
Annual Debt Service	4,600,000	4,911,669	3,634,635
DSCR	1.43	1.34	1.82
Buyer's Equity	20,000,000	40,000,000	29,600,000
Annual Cash Flow	2,000,000	1,688,331	2,965,365
Return on Cash	10.0%	4.2%	10.0%

Figure 5 – Source: Merrill Lynch

Anecdotally, the market consensus among CRE professionals is that property values have fallen 20-30% and cap rates have increased approximately 200 basis points, generally consistent with what is suggested in figure 5. However, the same market participants will also concede that for most properties, NOI is decreasing in the current economic climate and that investors' required rates of return have increased given the relative scarcity of investment capital available. If this is indeed the case, then the previous example suggests that the impact on value should be even greater.

Property Value Declines

The fact that property values may have declined more than 30% is exactly the fear in today's market climate. With relatively limited financing, there have been very few trades and as a result it has been difficult to assess current market values. The lending community is particularly fearful. Looking once more to the example in figure 5, except this time from the perspective of the lender, and the prospect of significant principal loss on the part of banks and lending institutions becomes increasingly likely.

The lack of affordable, or in some cases any, debt financing is the most significant obstacle currently facing the CRE market. Estimates are that approximately 40% of the \$3.4 trillion in commercial mortgages outstanding will reach maturity over the four-year period ending in 2012.¹¹ During that time, the relative average outstanding loan-to-value ratio of these loans may approach 100% LTV (figure 6). One of the larger issues is that the loans originated after 2005 were provided to investors at extraordinarily low interest rates and with minimal loan covenants. The underlying assets may be expected to generate enough income necessary to cover debt service and avoid default, but lenders are unable to take any action to protect their loan positions even though the prospects of full repayment at maturity are increasingly

¹¹ Source: PPR

unlikely. In many instances, these loans will hobble toward default at maturity. Many of the riskiest loans from 2005-2007 were five-year interest-only loans.¹² This provides for a large segment of the most problematic loans to mature after 2010 and the possibility of a more protracted and distressing resolution. It also raises the risk that many more bank failures may be inevitable.

Projected CMBS Loan-To-Value by Maturity

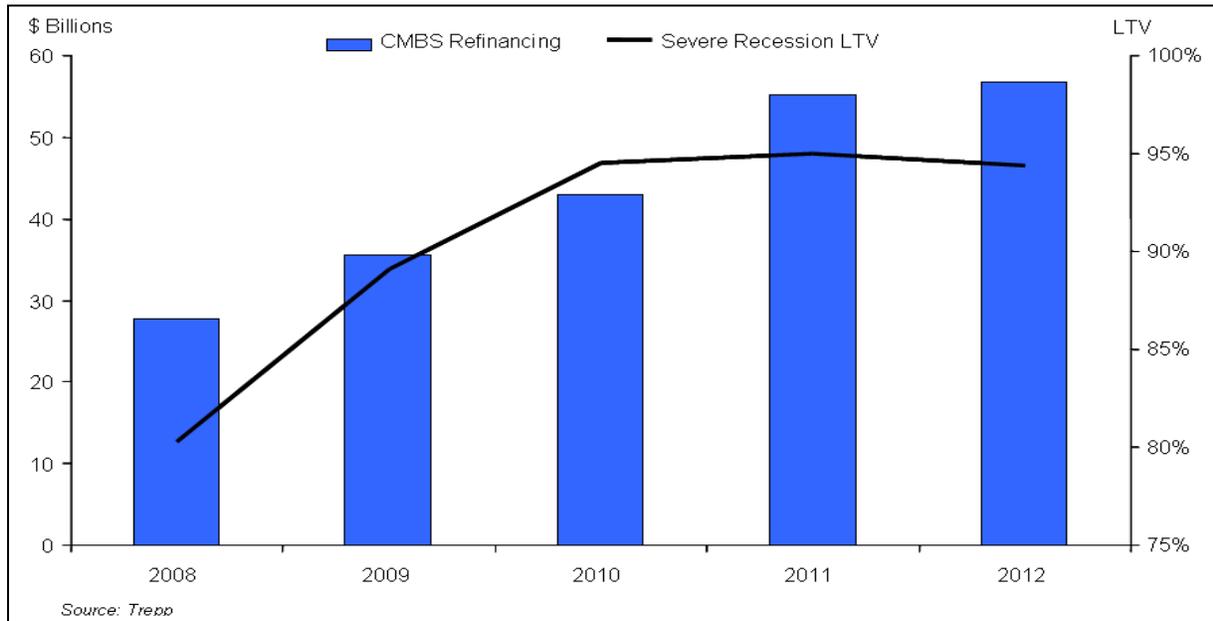


Figure 6 – Source: Trepp

National Problems

What lies next for the CRE market is uncertain. The severity of the current crisis for the commercial real estate market appears highly dependent upon the economy. CRE fundamentals are weak across almost every property category and comparisons are being made to the 1990s in an effort to estimate the extent of the market devaluation. Deutsche Bank recently published its commercial real estate outlook for Q1 2009 in which it estimates that property price declines of up to 35-40% can be expected. That would not only exceed the declines experienced in the early 1990s, but also push prices to those levels of early 2004. However, where the downturn in the 1990s was the result of over-building and excess supply, the current crisis is one of reduced demand. Rent declines and vacancy rates may approach those of the early 1990s even without the overhang of new inventories, and delinquencies could reach the peak rate of 6-7% experience during that era by 2010.¹³

What is certain, however, is that the CRE market will go through a painful but necessary process of delevering over the next several years. Unfortunately, the combination of deteriorating property fundamentals, and the resulting impact on cash flow and value, with more stringent market underwriting standards, increases the likelihood that a high percentage of the loans originated from 2005 – 2007 will not qualify for refinancing. In fact, assuming that the lending market has returned on a more permanent basis to conservative underwriting

¹² Source: Deutsche Bank

¹³ Ibid

standards (LTV <70%) it is anticipated that approximately two-thirds of loans maturing through 2012 would not qualify for refinancing.¹⁴

With greater than \$300 billion in CRE loans maturing annually through 2012, it was originally perceived that these loan maturities would fuel forced sales activity. Without question, there will be opportunities for those adequately capitalized to purchase defaulted loans or assets from fallen banks. However, with bank balance sheets precariously weak, many in the lending community are unwilling to book losses or post the increase in reserve requirements associated with foreclosure activity. With the vast majority of loans covering debt service, and banks either unwilling or unable to foreclose, it appears increasingly likely that the market may address the issue in the short term through extending loan maturities. Without additional intervention, however, it doesn't seem that time alone would be adequate to provide the asset appreciation required to eventually qualify for refinancing.

Portland Prospects

The failure of Pinnacle Bank in February, the first Oregon Bank to close since 1992, is indicative that the local market will also have its share of challenges. However, the outlook for Portland's commercial real estate market may not be as bleak as other areas of the country. It is not necessarily a result of regional market strength, but rather a combination of extenuating circumstances that may temper the local fallout.

Shorenstein Properties' Portland portfolio is certainly not nearly worth the \$300 per square foot transaction price today. However, Shorenstein's owner profile has traditionally been that of a durable investor utilizing modest leverage over a long-term investment horizon. There is little probability that the 45 buildings purchased, including the 369,000 square foot Congress Center and the 271,600 square foot Umpqua Bank Plaza will be dumped on the market in the type of distressed sale that may be seen in other localities. In addition, Portland came under the focus of out-of-market investors very late in the cycle. As a result, the market continues to be dominated by local investors and primary lenders generally attracted to the traditional attributes of the slow-growth, high barrier to entry Portland market.

This is not to suggest that Portland will not face significant challenges or declines in value. The prospects of even higher unemployment, higher vacancies, decreased traffic at the Port of Portland and the pressures of significant additions to the Portland office inventory will certainly be a drag on values. However, Portland did not see the extended wave of yield-chasing, high leverage, short-term investors that will feed distressed sales.

Seattle Scenario

Unfortunately, the same may not be said for Seattle, and it is likely that this credit crisis will impact that metropolitan area particularly hard. During the last cycle, Seattle emerged as a viable institutional investor market. The region had been previously bypassed as a market with few institutional quality assets, and a cyclical economy closely linked to the fortunes of Boeing. However the proliferation of a more diversified economic base generated strong outside demand. It was also one of the last markets to exhibit weakness, which many pointed to as proof of the strength of underlying investment fundamentals. Unfortunately, much of that optimism vanished with the collapse of Washington Mutual in February 2008 and, while Seattle burned hotter and longer than many markets, it may also fall harder.

Seattle is also one of the markets that is currently exhibiting some distressed sales activity. Some of the institutions which made market-entry decisions during the last cycle are now

¹⁴ Ibid

retrenching to their core markets at the expense of the Puget Sound region. The prospective sale of the recently listed Seattle Tower in downtown Seattle is being closely watched as an indication of market valuations. The property sold in 2004 to Trinity Real Estate for \$19.2 million, or roughly \$120 per square foot.¹⁵ In 2006, the property was purchased for \$36 million, or approximately \$227 per square foot.¹⁶ Now back on the market, speculation remains that value may revert very close to 2004 levels and could very well define the level of risk and returns that are required of commercial real estate investors in today's economic climate.

Federal Intervention

The government is highly motivated to prevent the damage to banks, insurance companies and other financial institutions that would be caused in the downward spiral of commercial real estate values brought on by the mass sale of distressed assets or foreclosed properties. In exactly what form or fashion the government will intervene is unclear, although it can be anticipated that the government will participate, and likely aggressively, to prevent market deterioration beyond what is necessary. In any event, the credit crisis and its resulting impacts are the defining events of the CRE landscape and will define the industry for at least the next half decade as the S&L crisis defined the markets of the late 1980s and early 1990s.



¹⁵ Source: Puget Sound Business Journal, December 3, 2004.

¹⁶ Source: Cushman & Wakefield, Marketbeat Snapshot, Third Quarter 2006.