

FORECASTS & TRENDS

The Economy and the Commercial Real Estate Bust

by Gary D. Halbert

There is broad agreement that we have seen the worst of the recession, and that GDP will show a positive gain for the third quarter. Most pre-report GDP estimates I have seen are in the +2 to +3% range for the third quarter. The actual number remains to be seen, of course.

There is also a growing agreement that we have seen the worst of the housing bust, as sales of new and existing homes rose briskly for the four months ended in July; however sales of existing homes unexpectedly fell slightly in August. Yet while the economy appears to be on the mend, at least for a while, and the housing market seems to be recovering, there is another serious threat to the economy and the credit markets just ahead – the continuing commercial real estate bust which is still getting worse. This problem has led numerous analysts to predict that commercial real estate may well be the next shoe to drop in the credit crunch.

The Economy Continues to Improve Slowly

As noted above, most forecasters believe the US economy has expanded at healthy rate in the third quarter. If so, that will be a welcome relief following GDP declines of -6.4% in the first quarter and -1.0% (annual rates) in the second quarter.

The Index of Leading Economic Indicators (LEI) rose 0.6% in August, marking the sixth consecutive monthly increase. This is perhaps our best indication that growth in the fourth quarter will be positive and could surprise on the upside, which is not surprising following the worst recession since the Great Depression.

Most analysts that I follow closely believe, however, that the economic recovery in 2010 will be rather anemic with GDP growth at or below 3% on average. Such estimates could prove too rosy, depending on what happens in the huge commercial real estate sector (details to follow).

As noted above, existing home sales dipped slightly in August following four consecutive monthly increases. New home sales in August were up fractionally (0.7%), well below expectations, following the 9.6% jump in July, the highest in almost a year.

Of course, any analysis of the overall economy would be remiss not to point out that, while things are improving on most fronts, the unemployment rate continues to rise – up to 9.7% in August from 9.4% in July – and will almost certainly continue higher for several more months at least.

Overall, it appears clear that the recession will end this year, and it is quite possible that we will see positive growth in GDP in the third quarter and fourth quarter. Most of the estimates I read for the second quarter are in the +2-3% range; most of the guesses I read

for the fourth are in the +3-4% range, which remains to be seen, especially in light of the potentially dangerous situation in the commercial real estate markets.

Plunge in Commercial Real Estate Values

US commercial real estate, valued at some **\$3.5 trillion**, has experienced a 39% decline in prices on average from the peak in late 2007, according to the MITCenter for Real Estate.

This current drop is considerably worse than the 27% commercial real estate decline associated with the savings and loan crisis of the late '80s and early '90s. You will recall that the S&L crisis precipitated the government-run Resolution Trust Corporation and the resulting seizures and auctions of hundreds S&Ls around the country.

The same conditions that caused the residential housing bubble, including the Fed's easy credit, lax lending standards and booming mortgage-backed securities underwriting on Wall Street, also drove commercial real estate overvaluation.

Recently, MIT reported that commercial real estate prices plunged 18% in the second quarter, which was the largest quarterly drop in the 25 years since MIT first published its Commercial Real Estate Price Index. MIT also reports that most commercial properties bought or refinanced in the last five years are now upside down on their loans, with current property prices having fallen below the finance or purchase price. Real Capital Analytics reports that owners have lost their entire down payments on about **\$1.3 trillion** worth of property.

According to several sources, nearly half of all the commercial real estate mortgage loans in the US are coming due within the next five years. Deutsche Bank, for example, believes that **65% or more** of these loans will fail to qualify for refinancing. Existing high vacancy rates will continue or worsen as long as the unemployment rate continues to rise.

We are hearing more and more talk about the plunge in commercial real estate values these days because commercial real estate value trends tend to lag the overall economy. There are many reasons for this – too many in fact that it is impossible to cover them in this short space.

Susan Smith, who is the director of PricewaterhouseCoopers' real estate advisory practice notes: ***“The biggest problem is that commercial real estate lags what happens in the economy. Companies are looking for ways to cut costs, many are continuing to reduce workers and are continuing to reduce their space needs.”*** As a result, commercial rental rates have taken a nosedive in most markets.

Ms. Smith and her team at PricewaterhouseCoopers conduct surveys each year of the commercial real estate market, and their latest survey concludes that the rise in vacancy rates and the plunge in rental rate are far from over and may well extend into 2011.

Office rents in New York and San Francisco may drop 20% in 2010 alone, the survey found.

The National Association of Realtors projects that retail vacancy rates will increase from 11.7% in the second quarter of 2009 to at least 12.9% in the same period of 2010, the highest vacancy rates since 1991. Likewise, NAR projects that office building vacancy rates will rise from 15.5% to at least 18.8% by this time next year.

More Trouble Ahead for the Banks

All of the above suggests the following: many of the banks that made commercial real estate have only realized a fraction of their losses. And as those losses continue to mount, we're likely to see more and more bank failures. Commercial real estate loans are not just concentrated among the nations largest banks; these loans are widely made by regional banks and even smaller banks.

Of the largest banks, San Francisco-based Wells Fargo has the largest share of the approximately \$3.5 trillion commercial debt securities, reportedly with 16.5% of its \$821 billion loan portfolio invested. JPMorgan Chase is reportedly a distant second with 5.4% of its portfolio invested in commercial loans, followed by Citigroup with 3.4%.

However, smaller banks – 92 of which have already folded this year as of mid-September, according to the FDIC, compared to 25 last year – are even more at risk because they will likely have a harder time accessing the crucial capital to offset rising defaults on commercial real estate loans, according to the TARP-inspired Congressional Oversight Panel's [August Oversight Report](#). The Oversight Panel noted:

“Unlike large banks that can sustain a certain number of defaults, even of large commercial loans, smaller banks may have far more difficulty in absorbing more than a few large loan losses. The FDIC’s statement that ‘banks have been able to raise capital without having to sell bad assets through the LLP’ may not reflect the reality for these banks.”

Indeed, the number of smaller banks expected to be seized by the FDIC is forecast to accelerate next year. The FDIC's “problem list,” of banks that run a higher risk of failure, grew to **416** in the second quarter, up from 305 in the first quarter. That's the highest number since the second quarter of 1994, following the S&L crisis, when there were 434 banks on the list.

As noted above, the S&L crisis resulted in a 27% decline in commercial real estate around the country. This time around the losses are even greater (39% so far) because the approximately \$3.5 trillion is over three times what it was during the early 1990s – meaning the potential for losses is steeper than ever before.

Glut of Commercial Mortgage-Backed Securities

Federal Reserve and Treasury officials are scrambling to prevent the commercial real estate sector from delivering another knockout punch to the US economy just as it

struggles to get up off the mat. Yet their efforts could be undermined by a surge in foreclosures of commercial property carrying mortgages that were packaged and sold by Wall Street as bonds. These loans are known as **Commercial Mortgage-Backed Securities (CMBS)**.

As discussed above, many US banks have high exposure to commercial real estate debt that they initiated through their own internal loans. In addition, many banks also bought CMBS and now have additional default risks that I will discuss in more detail as we go along.

Similar mortgage-backed securities (Sub-prime, Alt A, etc.) created out of home loans played a huge role in undoing that sector and triggering the global economic recession and credit crisis. Most sources estimate that there is around **\$700-\$900 billion** of CMBS outstanding at this time. These complicated products are being tested for the first time by the massive downturn real estate values discussed above, and so far the outcome so far hasn't been pretty.

One major problem is that many of these mortgages were simply poorly underwritten. In the era of looser credit in recent years, Wall Street's CMBS machine lent owners money on the assumption that occupancy and rents of their office buildings, hotels, stores or other commercial property would keep rising. **In fact, the opposite has happened.** The result is that a growing number of properties aren't generating enough cash to make principal and interest payments.

The other major problem is the growing inability of property owners to refinance loans bundled into CMBS when these loans mature. By the end of 2012, some \$153 billion in loans that make up CMBS are coming due, and close to \$100 billion of that will face difficulty getting refinanced, according to Deutsche Bank. Unfortunately, other sources estimate that twice that many CMBS loans will come due between now and 2012; and double the amount that will be difficult or impossible to refinance.

Even though the cash flows of many of these properties are enough to pay interest and principal on the debt, their values have fallen so far that borrowers won't be able to extend existing mortgages or replace them with new debt. That means losses not only to the property owners but also to those who bought CMBS - including hedge funds, pension funds, mutual funds and other financial institutions - thus exacerbating the economic downturn.

Many banks that hold traditional commercial real estate loans have chosen to extend the maturities and/or renegotiate the terms (this is one reason we haven't heard too much about it until recently). Banks have had a strong incentive to refinance because relaxed accounting standards have enabled them to avoid marking the value of the loans down.

Until now, banks have been able to keep a lid on commercial-real-estate losses by extending debt when it has matured as long as the underlying properties are generating enough cash to pay debt service. Unfortunately, CMBS are held by scores of investors,

and the servicers of CMBS loans have limited flexibility to extend or restructure troubled loans like banks do.

Mounting foreclosures in the CMBS sector will likely depress values even further as property is dumped on the market. And this, in turn, will likely put pressure on banks to write down the myriad of commercial loans on their books, thereby exacerbating the problem.

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