Will the Dark Cloud of Commercial Real Estate Blot Out the U.S. Recovery?

The below article was written by William Patalon, III, Executive Editor of Money Morning. ***Money Morning*** *delivers finance news and investment advice from around the world every morning directly to your inbox for free. For your free report, please visit www.moneymorning.com .*

Stock prices have rallied for awhile. The housing market has shown some early signs of live and some of the latest economic reports haven't been the disasters that many experts feared.

While this is hardly a portrait of an economy on a roll, there are enough bright spots to nurture a feeling that the U.S. economy is finally on a path to recovery – especially given the upbeat response the latest elements of the Obama administration's fix-it plans have received.

But there's a dark cloud in this picture. And it's big – big enough to potentially finish off the U.S. banking sector, blotting out the U.S. economy's new dawn.

The dark cloud is the commercial real estate sector. With rent prices falling and vacancies rising due to the recession-weakened economy, delinquencies on commercial mortgages are already escalating steeply. And the credit crunch bred from recession is often making it impossible for property owners to avoid deeper trouble by refinancing.

"It's a one-two punch combination: First, soaring vacancies take the wind out of positive cash flow; then the credit crisis hits like a rabbit punch, snapping off the main arteries to refinancing," says ***Money Morning*** Contributing Editor Shah Gilani, a retired hedge-fund manager and expert on the U.S. credit crisis who predicted the implosion of the commercial real estate sector several years ago. "This is like Samson hitting the ground. The giant asset class we call commercial real estate is not going to get up any time soon."

Here in the U.S. market, commercial real estate is worth about $6.5 trillion and is financed by an estimated $3.1 trillion in debt. And that debt is going bad at an escalating rate. In March, the delinquency rate on about $724 billion in securitized debt reached 1.8%. As percentages go, that's a pretty small number. In fact, it's less than a quarter of the housing market's record-breaking mortgage –delinquency rate of 7.88% for the fourth quarter, according to the Mortgage Banker's Association.

But don't let that 1.8% rate fool you: The delinquency rate on commercial real estate-debt has more than ***doubled*** just since September, according to a new Deutsche Bank AG (DB) report called "Commercial Real Estate at the Precipice".

With that increase, experts say the delinquency rate on commercial real estate has already almost equaled the rate achieved during the last U.S. economic slump, which took place at the beginning of this decade. And forecasts now call for the current downturn in

commercial real estate market to rival – and perhaps even exceed – the plunge of the early 1990s, when nearly 8% of all commercial real estate loans went sour. Banks and thrifts took nearly $50 billion in charges and nearly 1,000 lenders failed, ***The Wall Street Journal*** said. The fallout this time could be much worse – for three key reasons:

Commercial Real Estate is a Heavyweight Sector
Although soaring defaults on student loans, auto loans or credit cards won't help a nascent economic recovery; those slices of the debt market are dwarfed by their commercial real estate counterpart. What's more, the $3.1 trillion that makes up the commercial real estate debt market is three times the size it was during the early 1990s – meaning the potential for losses is steeper than ever before.

Commercial Real Estate is Closely Tied to Employment
The second factor is jobs. In the housing market, a loan default essentially affects a single family. In commercial real estate, a default typically signifies big problems at the company that owns or occupies the building or property that the loan finances. And those "big problems" typically translate into reduced jobs. This is debt that's backed by the mostly vacant downtown high-rise where your neighbor worked before his employer downsized; by the neighborhood mall that shoppers avoid after it lost its Starbucks, Circuit City, Linen 'N Things and Mervyns retail locations; or by a factory of a now-bankrupt supplier of arts for the General Motors Corp passenger car that's been cancelled.

A Nosedive in the Commercial Real Estate Sector Could Torpedo any Improvements the American Banking Sector Has Seen
Since 2007, 47 lenders have failed, of which one quarter had an exceptionally high exposure to commercial real estate loans. Until recently, the U.S. banking sector has been an economic "black hole," whose unending appetite for capital left nothing for actual economic stimulus efforts. That black-hole syndrome seemed to have been resolved recently, allowing the Obama administration to enact other stimulus plans. But many experts fear that a severe downturn in the commercial real estate sector might be enough to reopen this interstellar capital chasm blunting all other rebound initiatives. *Foresight Analytics LLC* estimates that as a result of the ongoing downturn, the U.S. banking sector could incur as much as $250 billion in commercial real estate losses, enough to cause another 700 banks to fail.

"Any bank that has a sizable book of commercial real estate loans could have serious problems in 1009," Jamie Peters, a bank analyst at Morningstar Inc. in Chicago told the ***Minneapolis Star-Tribune***.

This time around, compared to the early 1990s – banks left themselves no margin of safety in the form of "Tier I Capital", a measure of how well a lender can navigate serious levels of losses. The higher the ratio, the less likely a lender will be able to work its way through a stretch when loans start going bad.

In 1993, less than 2% of U.S. banks and thrifts had an exposure to commercial real estate that was more than five times their Tier I capital. By the end of last year, that ratio had spiked to 12%, involving about 800 banks and thrifts.

As ***Money Morning*** reported, the U.S. Treasury Department and the U.S. Federal Reserve are working on a program that would induce private investors to buy into debt backed by such income-producing commercial properties as office buildings, retail stores and hotels. The program – the Term Asset-Backed Securities Loan Facility, (TALF) – is seen as a way of breaking the toxic-asset logiam, and to bring capital to debt that can't be refinanced because of the ongoing credit crisis.

This is an attempt to avoid the [dangerous] "repeat of what happened on the residential side: A complete choking up, foreclosure disasters and increased stress on the banking system," Jeffrey DeBoer, chief executive of the Real Estate Roundtable, told ***The Journal.***

What has real estate executives really worried is the looming surge in commercial real estate loans coming due. Until now delinquencies on commercial real estate loans have stayed below historical levels (due mostly to the limited amount of speculative construction that's taken place in recent years. But delinquencies are now surging – in a big way – just as the volume of loans coming due is also spiking – and just as the few remaining lenders willing to make the kind of loans needed to refinance this debt are exiting the market.

"The credit crisis has got so bad that refinancing of even good loans may be drying up," says Richard Parkus, head of commercial-mortgage-backed securities research at Deutsche Bank, and author of the aforementioned *"Commercial Real Estate at the Precipice"* report.

Commercial real estate loans differ from their residential-loan counterparts, which borrowers repay after a set period of time – usually 30 years. Commercial mortgages usually are underwritten for five, seven or 10 years with big "balloon" payments due at the very end. At that point, the property owner usually turns the loan over and refinances it. A borrower's inability to refinance could force it to default.

All of a sudden, scores of experts are warning federal lawmakers that hundreds – or even thousands – of resort hotels, retail malls and shopping center properties and commercial complexes of all sorts are headed for, on the verge of, or are already in default, a ***Memphis Daily News*** report stated. The reason – <u>about $530 billion of commercial mortgages will be coming due for refinancing in 2009-2011 – with about $160 billion maturing this year,</u> even as credit for refinancing remains non-existent and cash flows from rents and leases are way down due to the recession, property researcher Foresight Analytics concluded. What's not clear is how soon the crunch will come or if it will come at all.

The Real Estate Roundtable, a key trade group for the industry, late last year predicted that more than $400 billion of commercial mortgages will come due through the end of 2009. Foresight Analytics estimates that $160 billion of commercial mortgages will mature next year. "Unfortunately, the commercial real estate market is even more vulnerable to economic cycles and here I'm talking about deep recession, than residential real estate," ***Money Morning***'s Gilani says.

The current recession, which started in December 2007, could be the wild card, Gilani says. If the U.S. economy continues to improve, as it seems to be, and as many experts predict will continue to, cash flows from properties won't keep declining and defaults won't escalate. Unfortunately, there's an inertia that takes hold during a downturn: Companies continue to slash jobs, shutter plants, close stores and otherwise cut expenses – often even after the broader economy shows early signs of new life. This inertia could be enough to keep commercial real estate vacancies to rise and defaults to escalate.

If that happens, it's possible the commercial real estate sector becomes the "tipping point" that could keep the U.S. economy ensconced in its current recession, or if the recovery is truly under way, push the U.S. market into a "double-dip" downturn. Time will clearly tell.