

An Insider's View of the Real Estate Train Wreck by David Galland

The below was written by David Galland, a contributing author to Whiskey and Gunpowder. Whiskey and Gunpowder, a free e-letter is the independent investor's daily guide to gold, commodities, profits and freedom. To subscribe, visit www.whiskeyandgunpowder.com.

Gary's Note: *The government has been enabling the real estate bubble (and sprawl) for years with agencies that subsidize mortgages. Now the chickens are coming home to roost as explained when David Galland interviews Andy Miller. Very few realize just how bad things are going to get for commercial real estate, but Andy is on top of it.*

The first time I spoke with real estate entrepreneur Andy Miller was in late 2007, when I asked him to serve on the faculty of a Casey Research Summit. As John Mauldin, a former faculty member himself, knows, we're very selective with our speakers. And there was no one in the nation I wanted more than Andy to address the critical topic of real estate.

My interest in Andy was due to the fact that he has been singularly successful in pretty much all aspects of the real estate market, including financing and developing large projects — such as shopping centers, apartment communities, office buildings, and warehouses — from one end of the country to the other. His expertise has also allowed him to build an impressive business providing assistance to large financial institutions that need help in dealing with problem commercial real estate loans. As you might suspect, business is booming.

Back in 2007, however, what most intrigued me about Andy was that he had been almost alone among his peer group in foreseeing the coming end of the real estate bubble, and in liquidating essentially all of his considerable portfolio of projects near the top. There are people that think they know what's going on, and those who actually know — Andy very much belongs in the latter category.

In fact, he initially refused to speak at our event, only agreeing very reluctantly after I had hounded him for several months. The reason for his refusal, I later found out, was that he had spoken at several industry events before the real estate collapse and had been all but booed off the stage for his dire outlook.

The happy ending of this story is that Andy's speech at our Summit was a rousing success, and he enjoyed it so much that he has now spoken at several, and has kindly agreed to sit for periodic interviews to keep our readers up to date on the latest developments in this critical sector. So far, Andy's real estate forecasts continue to come true.

As you'll read in the following excerpt from my latest interview with Andy, who now spends considerable time each day helping the nation's biggest banks cope with growing stacks of problem loans, he remains deeply concerned about the outlook for real estate.

No one has been more right on the housing market in recent years. So, what's coming next? Some of the housing numbers in the last few months look a little less ugly. Could housing be getting ready to get well?

MILLER: I don't think so. For all intents and purposes, the United States home mortgage market has been nationalized without anybody noticing. Last September, reportedly over 95% of all new loans for single-family homes in the U.S. were made with federal assistance, either through Fannie Mae and the implied guarantee, or Freddie Mac, or through the FHA.

If it's true that most of the financing in the single-family home market is being facilitated by government guarantees, that should make everybody very, very concerned. If government support goes away, and it will go away, where will that leave the home market? It leaves you with a catastrophe, because private lenders for single-family homes are nervous. Lenders that are still lending are reverting to 75% to 80% loan to value. But that doesn't help a homeowner whose property is worth less than the mortgage. So when the supply of government-facilitated loans dries up, it's going to put the home market in a very, very bad place.

Why am I so certain that the federal government will have to cut back on its lending? Because most of the financing is done via the bond market, through Ginnie Mae or other government agencies. And the numbers are so big that eventually the bond market is going to gag on the government-sponsored paper.

The public doesn't have any idea of the scale of the guarantees the government is taking on through Fannie, Freddie, and FHA. It's huge. If people understood what the federal government has done and subjected the taxpayers to, there would be a public outrage. But you can't get people to focus on it, and it's very esoteric, it's very hard to understand. But it's not something the bond market won't notice. The government can't keep doing what it has been doing to support mortgage lending without pushing interest rates way up. Refinancings of single-family homes are very interest-rate sensitive. Consumers have their backs against the wall. They have too much debt. Refinancing their maturing mortgages or their adjustable-rate mortgages is very problematic if rates go up, but that's exactly where they're headed. So anyone who's comforted by current statistics on single-family homes should look beyond the data and into the dynamics of the market. What they'll find is very alarming.

On that topic, recent data I saw was that something like 24% of the loans FHA backed in 2007 are now in default, and for those generated in 2008, 20% are in default, and the FHA is out of money.

MILLER: Fannie Mae had a \$19 billion loss for the third quarter of 2009, and they are now drawing on their facility with the U.S. Treasury. We have all forgotten that Fannie and Freddie are still being operated under a federal conservatorship. On Christmas Eve, the agency announced that they were going to remove all the caps on the agencies.

So what about commercial real estate?

MILLER: When I saw what was happening in the housing market, I liquidated all my multifamily apartments, shopping centers, and office buildings. I liquidated all my loan portfolios, and I'm happy I did.

Then it occurred to me in 2005 and 2006 that the commercial world had to follow suit. Why? Because it's a normal progression. Obviously, when single-family homes decline in value, multifamily apartments decline in value. And when consumers hit the wall with spending and debt, that's going to have an impact on retailers that pay for commercial space.

Furthermore, the financing for retail properties had gotten ludicrous. The conduits were making loans that they advertised as 80% of property value when they originated them, but in reality the loan-to-value ratios were well over 100%. And I say that to you with absolute, categorical certainty, because I was a seller and nobody knew the value of the properties that I was selling better than I did. I had operated some of them for 20 years, so I knew exactly what they were bringing in. I knew what the operating expenses were, and I knew what the cap rates were. And, you know, the underwriting on the loan side and the purchasing side of these assets was completely insane. It was ludicrous. It did not reflect at all what the conduits thought they were doing. They were valuing the properties way too aggressively.

I became very bearish about the commercial business starting in late '05. In fact, I think I was in Argentina with Doug Casey, sitting on a veranda at one of the estancias, and he and I were lamenting what was going on in the real estate business, and I said there was going to be a huge adjustment in the commercial market.

Beyond the obvious, that the real estate market has taken pretty significant hits and some banks have been dragged under by their bad loans, what has really changed in real estate since the crash?

MILLER: I think the first thing that changed was that people learned that prices don't go up forever. Lenders also saw that underwriting guidelines for commercial real estate loans, especially in the securitization markets, were erroneous. They realized that some of their properties had been financed too aggressively, but still, I don't think even at the fall of Lehman, anybody was predicting a wholesale collapse in commercial real estate. But they did see they should be more circumspect with loan underwritings. In fact, after the fall of Lehman, they completely stopped lending. I think they realized we had been living in fantasy land for 10 years. And that was the first change — a mental adjustment from Alice in Wonderland to reality.

Today it's clear that commercial properties are not performing and that values have gone down, although I've got to tell you, the denial is still widespread, particularly in the United States and on the part of lenders sitting on and servicing all these real estate portfolios. People still do not understand how grave this is.

Right now there are an awful lot of banks that do an awful lot of commercial real estate lending, and for about a year now you've been telling me that you saw the first and second quarter of 2010 as being particularly risky for commercial real estate. Why this year, and what do you see happening with these loans and the banks holding them?

MILLER: It's an educated guess, and it hasn't changed. I still think that it's second quarter 2010. The current volume of defaults is already alarming. And the volume of commercial real estate defaults is growing every month. That can only keep going for so long, and then you hit a breaking point, which I believe will come sometime in 2010. When you hit that breaking point, unless there's some alternative in place, it's going to be a very hideous picture for the bond market and the banking system.

The reason I say second quarter 2010 is a guess is that the Treasury Department, the Federal Reserve, and the FDIC can influence how fast the crisis unfolds. I think they can have an impact on the severity of the crisis as well – not making it less severe but making

it more severe. I will get to that in a minute. But they can influence the speed with which it all unfolds, and I'll give you an example.

In November, the FDIC circulated new guidelines for bank regulators to streamline and standardize the way banks are examined. One standout feature is that as long as a bank has evaluated the borrower and the asset behind a loan, if they are convinced the borrower can repay the loan, even if they go into a workout with the borrower, the bank does not have to reserve for the loan. The bank doesn't have to take any hit against its capital, so if the collateral all of a sudden sinks to 50% of the loan balance, the bank still does not have to take any sort of write-down. That obviously allows banks to just sit on weak assets instead of liquidating them or trying to raise more capital.

That's very significant. It means the FDIC and the Treasury Department have decided that rather than see 1,000 or 2,000 banks go under and then create another RTC to sift through all the bad assets, they'll let the banking system warehouse the bad assets. Their plan is to leave the assets in place, and then, when the market changes, let the banks deal with them. Now, that's horribly destructive.

Just to be clear on this, let's say I own an apartment building and I've been making my payments, but I'm having trouble and the value of the property has fallen by half. I go to the bank and say, "Look, I've got a problem," and the bank says, "Okay, let's work something out, and instead of you paying \$10,000 a month, you pay us \$5,000 a month and we'll shake hands and smile." Then, even though the property's value has dropped, as long as we keep smiling and I'm still making payments, then the bank won't have to reserve anything against the risk that I'll give the building back and it will be worth a whole lot less than the mortgage.

MILLER: I think what you just described is accurate. And it's exactly a Japanese-style solution. This is what Japan did in '89 and '90 because they didn't want their banking system to implode, so they made it easier for their banks to sit on bad assets without owning up to the losses.

And what's the result? Well, it leaves the status quo in place. The real problem with this is twofold. One is that it prolongs the problem – if a bank is allowed to sit on bad assets for three to five years, it's not going to sell them.

Why is that bad? Well, the money tied up in the loans the bank is sitting on is idle. It is not being used for anything productive.

Wouldn't banks know that ultimately the piper must be paid, and so they'd be trying to build cash — trying to build capital to deal with the problem when it comes home to roost?

MILLER: The more intelligent banks are doing exactly that, hoping they can weather the storm by building enough reserves, so when they do ultimately have to take the loss, it's digestible. But in commercial real estate generally, the longer you delay realizing a loss, the more severe it's going to be. I can tell you that because I'm out there servicing real estate all day long. Not facing the problems, and not writing down the values, and not allowing purchasers to come in and take these assets at discounted prices — all the foot-dragging allows the fundamental problem to get worse.

In the apartment business, people are under water, particularly if they got their loan through a conduit. When maintenance is required, a borrower with a property worth less than the loan is very reluctant to reach into his pocket. If you have a \$10 million loan on a

property now worth \$5 million, you're clearly not making any cash flow. So what do you do when you need new roofs? Are you going to dig into your pocket and spend \$600,000 on roofing? Not likely. Why would you do that?

Or a borrower who is sitting on a suburban office property — he's got two years left on the loan. He knows he has a loan-to-value problem. Well, a new tenant wants to lease from him, but it would cost \$30 a square foot to put the tenant in. Is the borrower going to put the tenant in? I don't think so. So the problems get bigger.

Why would the owner bother going through a workout with the bank if he knows he's so deep underwater he's below snorkel depth?

MILLER: It's always in your interest to delay an inevitable default. For example, the minute you give the property back to the bank, you trigger a huge taxable gain. All of a sudden the forgiveness of debt on your loan becomes taxable income to you. Another reason is that many of these loans are either full recourse or part recourse. If you're a borrower who's guaranteed a loan, why would you want to hasten the call on your guarantee? You want to delay as long as possible because there's always a little hope that values will turn around. So there is no reason to hurry into a default. None.

So that's from the borrower's standpoint. But wouldn't the banks want to clear these loans off their balance sheets?

MILLER: No. The banks have a lot of incentive to delay the realization of the problem because if they liquidate the asset and the loss is realized, then they have to reserve the loss against their capital immediately. If they keep extending the loan under the rules present today, then they can delay a write-down and hope for better days. Remember, you suffer if the bank succumbs and turns around and liquidates that asset, then you really do have to take a write-down because then your capital is gone.

So here we are - we've got the federal government again, through its agencies and the FDIC, ready to support the commercial real estate market. They've taken one step, in allowing banks to use a very loose standard for loss reserves. What else can they do?

MILLER: Well, obviously nobody knows, but I can guess at what's coming by extrapolating from what the federal government has already done. I believe that the Treasury and the Federal Reserve now see that commercial real estate is a huge problem. I think they're going to contrive something to help assist commercial real estate so that it doesn't hurt the banks that lent on commercial real estate. It'll resemble what they did with housing.

They created a nearly perfect political formula in dealing with housing, and they are going to follow that formula. The entire U.S. residential mortgage market has in effect been nationalized, but there wasn't any act of Congress, no screaming and shouting, no headlines in the *Wall Street Journal* or the *New York Times* about "Should we nationalize the home loan market in America." No. It happened right under our noses and with no hue and cry. That's a template for what they could do with the commercial loan market. And how can they do that? By using federal guarantees much in the way they used federal guarantees for the FHA. FHA issues Ginnie Mae securities, which are sold to the public. Those proceeds are used to make the loans. But it won't really be a solution. In fact, it will make the problems much more intense.

Don't these properties have to be allowed to go to their intrinsic value before the market can start working again?

MILLER: Yes. Of course, very few people agree with that, because if you let it all go today, there would be enormous losses and a tremendous amount of pain. We're going to have some really terrible, terrible years ahead of us because letting it all go is the only way to be done with the problem.

Do you think the U.S. will come out of this crisis? I mean, do you think the country, the institutions, the government, or the banking sector are going to look anything like they do today when this thing is over?

MILLER: I know this is going to make you laugh, but I'm actually an optimist about this. I'm not optimistic about the short run, and I'm not optimistic about the severity of the problem, but I'm totally optimistic as it relates to the United States of America. This is a very resilient place. We have very resilient people. There is nothing like the American spirit. There is nothing like American ingenuity anywhere on Planet Earth, and while I certainly believe that we are headed for a catastrophe and a crisis, I also believe that ultimately we are going to come out better.

Andy Miller is the co-founder of the Miller Frishman Group (MillerFrishman.com), which includes three companies serving different sectors of the real estate market – from mortgage brokerage and banking, to the building, management, and marketing of commercial real estate across the United States. His firm is currently deeply involved in the distressed real estate business, assisting lenders across the nation with their growing portfolios of non-performing loans.