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Opportunities from forced sales

Such sales by distressed owners will help to establish pricing benchmarks for potential investors and their lenders

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WHILE a gloomy mood prevailed at the Commercial Real Estate Finance/Multifamily Housing Convention & Expo held last month in San Diego, California, one came away with an expectation that the paralysis affecting US commercial property markets finally will begin to evaporate as 2009 unfolds.

A combination of loan maturities, constrained refinancing options and deteriorating fundamentals will force the hands of overleveraged property owners. The ensuing series of forced sales will provide pricing points from which potential investors can begin to develop plans for possible purchases

The state of the US commercial property markets remained opaque during 2008, primarily due to a relative paucity of transactions. According to Jones Lang LaSalle, the total volume of transactions declined from US$437 billion in 2007 to US$126 billion in 2008.

Many buyers and sellers remained at a stand-off, with sellers holding fast to values supported by 2007 appraisals and buyers being constrained by limited financing options and expectations of deteriorating property values. Moreover, the fundamentals of commercial properties appeared to be adequate for the first three quarters of 2008.

Suspended animation

For example, the Fitch Ratings US CMBS loan delinquency index, which measures the commercial mortgage-backed securities loans that are at least 60 days delinquent, stood at 0.45 per cent at the end of September 2008, a level that compared favourably with the historical annual average of 0.79 per cent.

That state of "suspended animation" rapidly deteriorated during the fourth quarter of 2008, as commercial property markets were buffeted by the financial crisis accentuated by the bankruptcies of Lehman Brothers and several national retailers and an escalating unemployment rate, which reached 7.2 per cent.

According to Moody's Investors Service, property values at the end of December 2008 had declined by more than 16 per cent from the October 2007 peak. The Fitch Ratings US CMBS loan delinquency index had increased to 1.15 per cent at the end of January 2009.

Finally, as of December 2008, Real Capital Analytics had identified US$4.5 billion worth of properties that had been surrendered to lenders and another US$21.2 billion worth of "troubled" properties, as evidenced by foreclosure proceedings, default notices or borrower bankruptcies.

Notwithstanding this accelerated deterioration in property fundamentals, a common refrain at the San Diego convention was that market participants were "in denial" as to changed realities. During the intense competition and favourable loan terms available in 2005 till 2007, many property owners simply paid too much and now must recognise that their equity has been wiped out by subsequent price declines.

Senior mortgage lenders that had extended credit based on *pro forma* rental increases and other loose underwriting criteria have been loathe to recognise their loan losses and the resulting hits to their balance sheets. This state of denial has been prolonged by the hopes raised by federal government interventions in the credit markets.

Looming loan maturities and deteriorating property fundamentals during 2009 will force market participants to come to grips with a dramatically altered landscape. Owners face stringent loan terms, decreasing property values, and reduced cash flows from declining levels of occupancies and rents.

While many of the approximately US$171 billion of maturing commercial loans will be extended, the inability of some borrowers to contribute additional equity or secure refinancing will result in a significant increase in loan delinquencies and defaults, with Fitch Ratings estimating that the commercial loan delinquency rate will reach 3 per cent by year's end. "Forced sales" by distressed owners will help establish pricing benchmarks for potential investors and their lenders.

Pricing benchmarks will evidence a downward trend during the course of 2009. With the unemployment rate expected to exceed 9 per cent, vacancy rates for all major property sectors (as forecast by Property & Portfolio Research) will reach historic (or near historic) highs during 2009-2010. The inevitable weakening in property cash flows will further erode property values. As re-pricing is imposed by market forces, Jones Lang LaSalle expects that capitalisation rates will approach an average of at least 8-9 per cent nationally, with significant variances across markets and sectors.

In assessing forced sales and other opportunities presented in the US commercial property markets, international investors must contend with the constrained financing environment. The commercial mortgage-backed securities market, which provided up to 40 per cent of property financing during the market peak of 2006-2007, is completely closed.

National and regional banks are focused on rebuilding their balance sheets. Life insurance companies are concentrated on existing borrowers and handling maturing loans.

In addition, amounts allocated to the property sector will be reduced by the "denominator effect" resulting from a decline in a firm's overall assets. Reduced allocations will further eroded by competition presented by "AAA" CMBS bonds with attractive yields of 13 per cent or higher.

Moreover, loan terms will be stringent and expensive. A Federal Reserve Bank survey revealed that 87 per cent of banks tightened lending standards during the fourth quarter of 2008. A 60 per cent loan-tovalue requirement based on conservative underwriting and "recourse" financing are becoming commonplace.

In addition, "spreads" remain elevated, as evidenced by 450-500 basis point spreads above the Ten Year US Treasury security for 10-year fixed rate loans recently reported by Cushman & Wakefield Sonnenblick Goldman.

While the depth of the current recession and the effects of the federal government's intervention pose pain and uncertainties for market participants, 2009 will bring some long-awaited clarity to US commercial property markets and provide investors with data from which investment opportunities can be assessed.

As the result of forced sales by distressed borrowers and severely limited financing options, investors possessing ample equity and a long-term investment horizon will be able to take advantage of the attractive pricing of certain high quality assets.❖

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