

WAITING FOR THE OTHER SHOE

By C. Daniel Clemente

A few weeks ago, Treasury Secretary Henry Paulson opined that “The worst of the US’s credit crisis may have passed.” The former president of Goldman Sachs should know better. We’ve only seen part of the sub-prime mortgage meltdown thus far. The other shoe is about to drop, and the impact will be dramatic.

The mentality that produced the sub-prime crisis among residential lenders was also at work among bankers who originate commercial real estate loans. But it’s not the resetting of adjustable interest rates that will bring on the second half of the sub-prime crisis. It’s the coming due of currently performing commercial real estate loans that were written between 2002 and 2007.

These loans, many of which were subsequently sliced and diced into Commercial Mortgage Backed Securities (CMBS), are written for much shorter terms than residential mortgages, and the ticking sound you hear is the second credit time bomb, set to explode as this debt starts maturing between 2009 and 2012.

Several factors will soon combine to produce a perfect storm in commercial real estate:

A weakening economy reduces demand for commercial real estate space, which leads to a higher vacancy rate. That produces a drop in rental rates, resulting in less operating income. And as surely as night follows day, the appraised value of the property declines.

Mortgage underwriting standards, meanwhile, have tightened up substantially as a result of the existing credit crisis. So when the loans start maturing next year, building owners will not be able to refinance at the same loan-to-value ratio. Whereas loans of 80 to 100% were common prior to August 2007, the current standards seldom exceed 65%. Add to this the fact that the valuation method most commonly used today is based on *actual net operating income*, while, during the credit bubble between 2002 and 2007, underwriters allowed buildings to be valued on *projected income*, which often turned out to have little basis in reality.

It is fair to say that investors who typically provide equity capital are not standing on the sidelines waiting to rescue owners who overpaid for their commercial properties. And so we face a situation in which first trust commercial mortgages are coming due even as net operating income is dropping and underwriting standards are being tightened. Decreasing loan-to-value ratios are creating the need for more equity capital, but that capital just isn’t available.

How large is the problem? Something on the order of a trillion dollars’ worth of loans have been made over the last five years. With a large percentage of those loans maturing in the next five years, it is not unrealistic to expect a drop in the value of commercial real estate of as much as 30 percent.

Can large commercial banks withstand another round of losses equal to what they’ve already sustained in the residential arena? Already, groups of investors to whom the big banks have off-loaded home mortgages are suing for fraud and improper due diligence. When the residential mortgage crisis spreads to the commercial side, will the Fed attempt to bail them all out, or will we witness the sort of widespread failure of financial institutions we’ve seen in the past – in the 1930s (banks) and the 1980s (S&Ls)?

As Fed Vice Chairman Donald Kohn noted recently, economic conditions remain “quite difficult” and added, “We are in uncharted waters when the financial system becomes so disrupted.”

The initial losers in all this will be commercial real estate titans who caught the speculative fever and leveraged themselves into disaster. As reported, Harry Macklowe was able to leverage \$50 million to more than \$7 billion in his multi-billion-dollar play to own seven Manhattan trophy skyscrapers. Potentially, he is among the first to suffer the consequences when, as reported, he defaulted on \$7 billion in short term loans on the buildings earlier this year. It was a classic case of sub-prime borrowing. He may have paid far too much, based on unrealistic projections of income, and lost his gamble that the market would continue to ignore inflated values.

But the list of potential losers will get much longer, and will include all of us, because the U.S. financial system is ill prepared to withstand another hit of the size and scope of the sub-prime shock of the past year. There will be winners, too – those with cash to invest and the good judgment to know when it’s time to move in and pick up solid properties at reasonable prices.

In the long run, the commercial market, like the residential market, will return to some semblance of reality-driven pricing, and that will be good for everyone. But in the meantime, there is much more pain to come.