Commercial real estate bust looms

Developers face huge crunch as downturn hits office buildings, malls, hotels
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That big whoosh you're hearing is the air rushing out of a commercial real estate bubble.

More than two years into the worst housing crisis in decades, commercial real estate is shaping up as the second half of what some are calling a “double bubble.” Owners of shopping malls, hotels, office space and apartment buildings — and the bankers who financed them — face a major crunch over the next two years as the mortgages on those properties start coming due.

Much like homeowners who now owe more on their mortgage than their house is worth, many commercial property owners have seen the value of their properties plummet, increasing the risk of default on hundreds of billions in commercial real estate loans.

That is expected to put more stress on thousands of banks that have already been deemed “not too big to fail.”

“I have never seen anything this bad,” said Dan Tishman, CEO of Tishman Construction, one of the nation's leading construction and management firms, comparing the current slide to major commercial real estate busts in the 1980s and '90s.

Even as economists and federal officials point to recent signs that the recession may be ending, there’s widespread concern that commercial real estate could pose a threat to the recovery. Federal Reserve Chairman Ben Bernanke told members of the House Financial Services Committee this month that "commercial real estate remains a very serious problem."

Though the market is only about a third the size of the $22 trillion residential market, in some ways the problem for commercial real estate is more severe. Unlike home mortgages that run for 15 or 30 years, much of the roughly $1.6 trillion in commercial real estate loans outstanding involves much shorter terms of three to seven years. Many of the loans were written at the height of the boom.

“There was this unbelievable bout of lending that occurred all on a very short term,” said Tishman. “With short maturities you’ve squeezed the accordion as close as you can get and caused a lot more refinancing in a short period of time.”

Commercial real estate became hugely popular with bankers during the boom. In 2006, commercial real estate made up 56 percent of U.S. banks’ loan portfolios up from 40 percent a decade earlier, according to FDIC data. For smaller banks with assets under $1 billion the concentration is even higher. Some 74 percent of all loans held by smaller banks are secured by commercial real estate. These roughly 6,500 banks represent some 90 percent of all U.S. banks.

The risk for consumers is that heavy losses on commercial real estate could force banks to tighten lending for home mortgages, car loans and credit cards even further. It also could force bankers to try to offset commercial loan losses by accelerating sales of foreclosed homes, which could put further pressure on home prices.

For commercial real estate owners, the problem starts with the impact of the recession on their properties. Massive layoffs have left office buildings with unrented space. The slowdown in consumer spending is hitting owners of malls and retail space where foot traffic has dried up. Hotel owners have been hurt by the slowdown in travel and tourism.

On top of lost rent, commercial real estate owners who bought properties at the height of the boom have suffered the same fate as homeowners and suffered plunging values. From the peak in mid-2007, commercial property values are down by some 35 percent, according to Moody’s.

As commercial real estate loans come due, property owners face the same dilemma as many homeowners. If they sell the property, they’ll take a big loss. But to refinance, they’ll have to come up with a lot of cash to make up for the value lost since they took out the loan.

Most lenders are not especially interested in foreclosing because they’ll lose money selling into a distressed commercial real estate market. That’s prompted lenders to undertake a strategy of what industry insiders are calling “pretend and extend."

As long as the commercial property owner is making payments, bankers are willing to delay refinancing for a few years in hopes that the economy and real estate market improve. But it remains to be seen whether that strategy will work.

‘I don’t think the banks can hold out that long,” said Lesley Deutch, who follows the commercial real estate market for John Burns Real Estate Consulting. “There was a lot underwritten during (the boom); there’s just too much to refinance, and the values have gone down too significantly."

A lot depends on how well the economy recovers in the next several years. If companies begin hiring again, empty space in office buildings will begin to fill up, shuttered stores in malls will reopen and hotel owners will see occupancy rates rise. But even if that happens, it's not clear how long it will be before these properties regain their lost value.

“So many of those assets were acquired at top dollar,” said Susan Smith, director of the real estate group at Pricewaterhouse Coopers. “When you add on top of that the significant amount of debt that was used to acquire many of these real estate properties, I think you are looking at a much more troublesome problem down the road with commercial defaults than residential if something doesn't happen to facilitate refinancing.”

Some commercial property owners won't have a patient banker to talk to when it comes time to try to postpone their refinancing. That's because about a third of commercial loans are held by investors who bought commercial mortgage-backed securities, or bonds backed by the interest payments on those loans.

Because each loan is held by dozens of investors, there is no mechanism for negotiating an extension, even if there were new investors to buy fresh mortgage bonds. Tishman estimates that some $200 billion of these bonds will need to be refinanced in the next year, or about four times the annual volume during the lending boom.

“The reason that everyone is projecting the pain yet to come in commercial real estate is because the bulk of this debt that was done at high valuation, and high leverage has yet to mature,” said Michael Pollock, general counsel of The Ashforth Co., which owns, develops and invests in commercial real estate. “We're really just seeing the tip of the iceberg."

Though there's widespread agreement that a financial crunch is looming, some think the commercial real estate market may escape the kind of collapse in residential housing that brought down the U.S. economy. For one thing, the market is smaller.

Bankers also have time to prepare for the crunch over the next few years. Tishman says he hopes federal regulators and legislators will be more proactive this time in heading off the problem.

“Washington is no longer in the position to just float every industry there is,” he said. “But when they see an industry that's in need, they are going to do something about it before they will let it take the general economy down like the housing market and Lehman did.”

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