

Commercial Real Estate Loans: Are you Ready for the Storm?

BY: GARY GROTKE

These are already difficult times for many financial institutions, but things are going to get much tougher long before they start to improve.

As bankers, many of you have already been hit with a wave of defaults on construction and land development loans, and on 1-4 single family mortgage loans. These loans typically are the first to turn sour as the economy deteriorates and heads into recession. Unfortunately, in spite of some preliminary signs of firmness, there are more such defaults and foreclosures coming. It is not a huge surprise that government programs to stem the tide are either poorly designed (as of this writing there is still no resolution of what to do with 2nd mortgage holders when the underlying mortgage loan is modified) or ineffective in addressing the bulk of the problem.

What about commercial real estate?

The picture is even gloomier as we look to the future when it comes to commercial real estate loans. The following predictions and forecasts followed by a quote from George Soros create a horrific picture:

- Office vacancies are forecast to rise to almost 20% nationwide (*WSJ Apr 3, 2009*);
- Wachovia Bank economists project unemployment to reach 10.8% (Bloomberg radio Apr 8, 2009);
- Retail store closings are expected to exceed 200,000 stores, along with 2,000 to 3,000 malls going bankrupt (*ABC News Dec 30, 2008*);
- 20% of hotels will be unable to cover debt service payments from operations (*WSJ Jan 27, 2009*);
- Industrial vacancies are the highest since 2004 (*Jones Lang LaSalle, Winter 2009*); and
- Commercial property sales plunged 73% last year (*USA Today Jan 12, 2009*).

“Commercial real estate has not yet fallen in value,” Soros, speaking at a forum in Washington, said. “It is inevitable, it is written, everybody knows it, there are already some transactions which reflect and anticipate it, so we all know, they will drop at least 30 percent.” (*Quote from George Soros taken from Bloomberg.com Mar 26, 2009*)

Even though we are almost 18 months into the current recession, the real problems are just beginning for most banks, especially for the banks that avoided the “toxic” residential real estate mess. Commercial real estate loans do not typically become problematic until the middle or end of a recession. This is because once the recession is underway consumers and businesses respond by reducing spending, and for businesses by cutting jobs and production. This begins a self-reinforcing cycle whereby job cuts further depress consumer spending, which further reduces demand leading to additional cutbacks and in some cases business closures and bankruptcies.

Hospitality is the leading indicator for commercial real estate problems, as most of their customers are not subject to any type of long or even medium term commitment. Hence, as the economy sours, both leisure and business travelers pull back resulting in an immediate and negative impact on hotel revenues, which they are experiencing now. Office, store and industrial tenants typically have leases that cushion and delay the impact on their owners.

Some estimates are for a total of \$80 billion in commercial real estate loan defaults over the next couple years. Stores, restaurants, hotels, factories and offices are all facing lower demand and as a result lower revenue forecasts. These businesses will respond by working to reduce costs, including rents and/or debt service. Many others will simply not survive – Bennigan’s Restaurants, Circuit City, KB Toys, Whitehall Jewelers, Linen ‘n Things, Steve and Barry’s and Shoe Pavilion are already gone. There will likely be many other prominent, national retailers

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that are unable to weather the current downturn. The result will be higher vacancies, lower rents and a further depression in property values.

This crisis may also precipitate some fundamental and structural changes in our economy and in consumer spending habits. Specifically, there seems to be a general recognition that \$45 steaks and \$300/night hotel rooms may be too extravagant, and consumers in general may move forward even after the recession is over with more prudent and modest spending habits. This too could have a significant impact on the future prospects for a number of businesses and ultimately the underlying value of some of the bank's collateral.

What will landlords and owner/occupants do in response to this situation?

Well, some like Bennigan's Restaurants will just throw in the towel and simply let the courts wind up their business affairs, including dealing with their loans and commercial real estate holdings. In these cases, lenders will end up "realizing on their collateral" (as one of my favorite real estate companies used to describe loan foreclosures in their financial statements) or in other words, lenders will end up with their collateral as OREO.

Others will respond the way they have done in the past during turbulent times. They will ask for debt relief, lower payments or payment deferrals, cash flow mortgages, extended loan maturities, covenant waivers, and on and on it will go. In short, many will ask for more time with the hope that the economy and their business prospects will improve.

What should lenders do in response to their borrower's requests for concessions?

Unfortunately, there is no simple, "one-size-fits-all" answer to this question. The real answer involves much hard work, analysis and decision-making.

In short, as lenders you must evaluate each request on its merits. Furthermore, you must evaluate not only your history and relationship with your borrower, but also the value and prospects for the collateral. The single family subdivision that fronts the interstate that looked pretty good before the market tanked may not seem quite so attractive now. As such, any payments that the borrower/developer may be willing to make may be worth accepting in exchange for a little more time, assuming the borrower/developer can be trusted not to further depress the value of the collateral.

Finally, consider the bank's overall portfolio of real estate, taking into account both current and future projections of OREO and loan work-outs. For example, if the bank already owns four strip centers in one village, the bank may want to strongly consider accepting a reduced payment plan from a borrower that owns another such center, rather than pushing toward foreclosure.

What should lenders do with their growing portfolio of OREO?

Treat it like an asset, not a liability!

Work with your boards and regulators to get them to understand that your real estate must be managed, like any other aspect of your business. It cannot simply be dumped. Help them to recognize the seriousness of the situation, and the fact that strategies that worked in a functioning real estate market will not be effective in the coming crisis. Not when there will be a huge supply of commercial real estate in the hands of institutions (that in many cases will simply want to *get rid of it!*). And not when capital is constrained.

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Instead, engage experienced real estate people, either internally or through outsourcing arrangements, to manage these assets with your management team. Develop a strategy and plan that is based upon internal projections of your OREO and loan work-outs. Start planning now before it is too late or your institution may end up dealing with the crisis on an ad hoc basis.

Certainly some properties can be sold immediately, but others require careful review and consideration. Simply hiring brokers and real estate agents to list and sell the properties will not yield even close to the optimum result. The market is extremely efficient. As such, the market will identify the quality assets and the offers will flow in on those assets, probably at heavily discounted prices because investors know that “bank owned” typically means a motivated seller. In effect, they will hope to steal the quality assets, and leave you with the garbage. Given the overall lack of liquidity in the market (as a result of the massive deleveraging that is going on), there will not be enough money to purchase all of the OREO that the banks will have. As such, lenders must be prudent, lenders must have a plan and lenders must not just let the market “*cherry pick*” their best assets.

Although these commercial real estate loans were made in good faith with the reasonable expectation that they would be fully repaid, and in consideration of the value of the underlying collateral as a back stop, the ultimate result is not going to be as planned. As lenders, you already have a working understanding of the real estate fundamentals in your markets. This understanding was sufficient to make sound loans in normal times and to manage and dispose of the small amount of workouts and OREO that occurred since the last melt-down in the late 80’s and early 90’s. Unfortunately, your real estate issues will now reach a level that is well beyond your original expectations. Many lenders will be taking a much larger role in the real estate business going forward, both through extended and “hands-on” loan work-outs and through direct ownership, management, leasing, marketing and sale of real properties. Let’s start planning now!



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