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Here we go again: S&L redux and the CMBS era

Most real estate investors understand that commercial real estate is a classically cyclical business, with values rising and falling on the changing fundamentals of supply and demand. But what most investors miscalculate is the length and power of the cycle. Also few investors are aware of the enormous effect that mortgage availability has on values. Real estate cycles typically last 15 and 20 years. The previous cycle peak for commercial real estate was 1989, when overall cap rates nationally were at extreme lows (6.5 percent to 7 percent), which puts the current cycle in its 18th year. While current real estate fundamentals such as vacancy are relatively low, vacancy rates for most commercial real estate during the previous cycle were at their worst in 1989 – the same year that cap rates were low and values peaked. Why would values also peak in face of worsening vacancy?



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rates rose as lenders became reluctant owners, and distressed selling flooded the market.

If this sounds eerily familiar, it should. The new kids on the block this time around are conduit lenders, who packaged and securitized commercial loans into commercial mortgage-backed securities pools. Like the S&Ls before, conduit lenders were motivated by origination fees and lacked the scar tissue of previous cycles. As CMBS lenders strove for market share, underwriting standards deteriorated, and once again, loans were “priced to perfection.”

Credit standards are now tightening rapidly and defaults are starting to rise. This time, CMBS markets have exceeded the impact of the S&L lending during the 1980s. As shown on Chart 2, CMBS lending exceeded the S&L peak. This means the unwinding likely will be more severe than it was in the S&L crisis, even though fundamentals are stronger. The exogenous shock is the current recession in 2008-2009. Because the deleveraging is only just beginning, the bottom is not likely to occur until 2011 or 2012, after lenders (or regulatory agencies) clear out the bad commercial real estate loans at severe discounts.

The answer is a flood of easy mortgage availability from the new kid on the block – the savings-and-loan industry. As shown on Chart 1, commercial mortgage lending from S&Ls rose by 113.7 percent from 1981 to its peak in 1987. As new entrants into commercial lending, the S&Ls underwrote many of those loans more aggressively, using lax standards. In response, traditional lenders – banks and insurance companies – were forced to compete in order to maintain market share. The flood of mortgage capital pushed values up, even as fundamentals weakened. This all came crashing down as loans, “priced to perfection,” began to fail with exogenous shocks. Defaults rose dramatically. By early 1991 (the earliest data available), the delinquency rate for commercial real estate loans spiked to 12.57 percent. In other words, one of every eight commercial loans was nonperforming. Congress created the Resolution Trust Corp., and total commercial real estate lending declined through 1994. Without leverage – the lifeblood of commercial real estate – cap

■ **What to do?** For investors who are long in cash, the good news is that there will be bargains, although those bargains may be three to four years away. In the meantime, there are opportunities in hard-hit sectors of residential real estate, especially for contrarian investors willing and able to buy and wait for residential recovery. In our shop, we have started Condo Capital Solutions, which is buying troubled condo projects and notes in distressed markets, including Florida, Arizona and

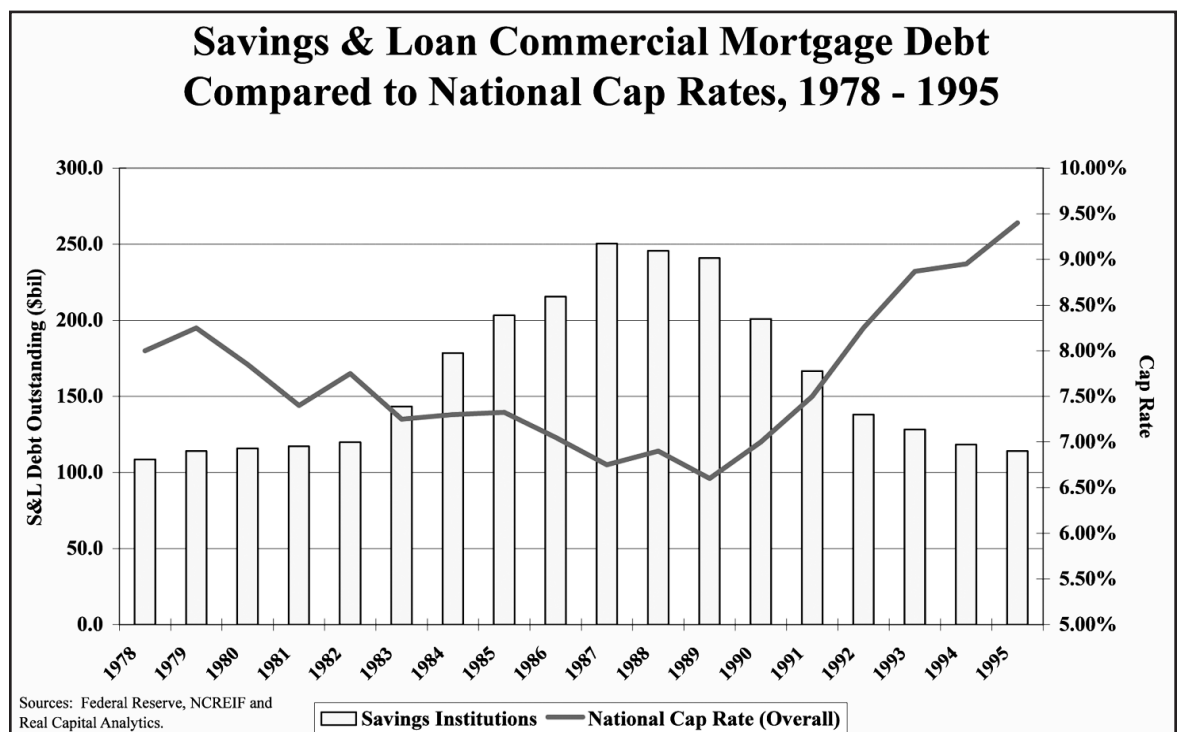


Chart 1

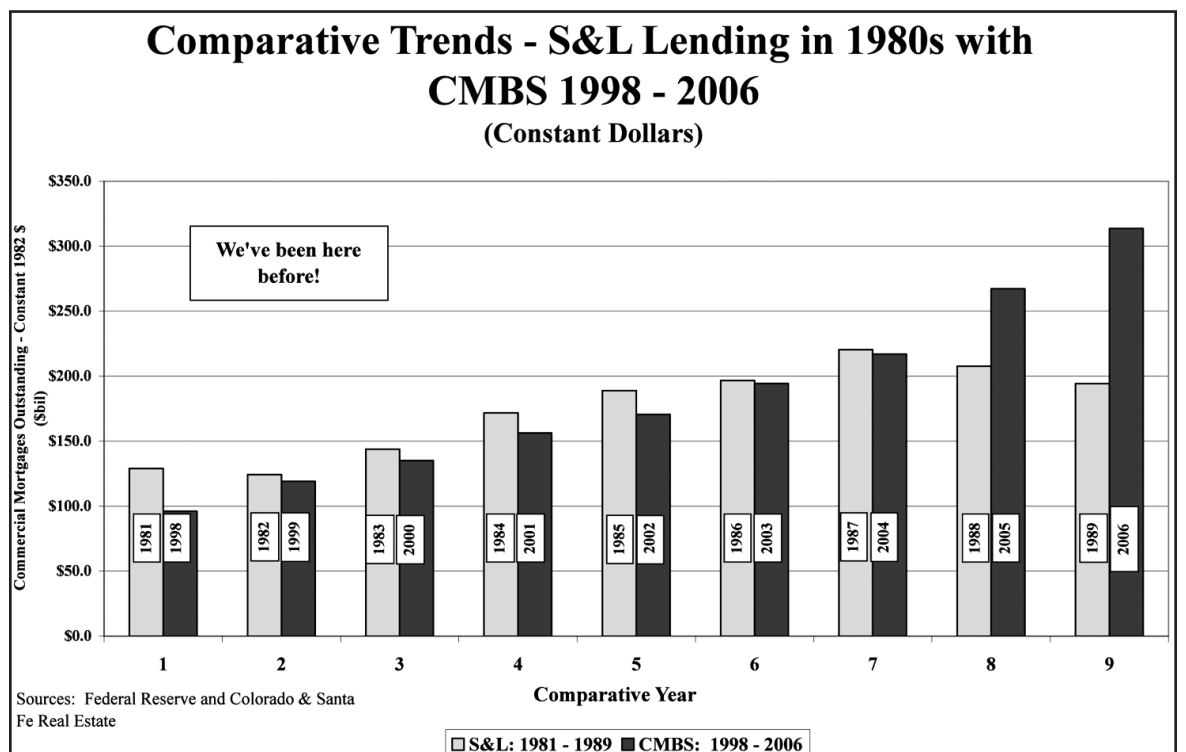


Chart 2

Denver.

With respect to a buying commercial, many investors are tempted to buy now. However, our own buying history during the S&L/RTC era has shown that the most profitable buys occurred as late as 1994 – five years after the last cycle trough.

By then, sellers and lenders had capitulated and were selling at significant discounts.

In the next few years, our strategy will be similar to the early 1990s. We'll be patient buyers looking for discounts of between 30 percent and 60 percent of peak value. In the next

three years, loans will fall into default and properties will be deeded back to lenders. Until then, a large bid-ask gap is in place. Nonetheless, a few deals may occur that price in the market deterioration (current recession and future asset deflation) reflected in rising cap rates.▲