

Special Asset Services

Commercial Real Estate Loan Forecast

SEPTEMBER 2009

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Where is the Tsunami?

Recently we wrote about an impending 'tsunami' of commercial real estate foreclosures. It is now generally accepted that the problems of commercial real estate run very deep, however the tsunami has yet to strike. Why is this? How are markets reacting? How should lenders be reacting?

Why So Slow?

We have seen over the last 24 months how globally interconnected financial markets are in today's world, how quickly information is disseminated and as a result how quickly markets react. So why hasn't the commercial real estate tsunami materialized?

A Lagging Indicator

Commercial real estate is a lagging indicator. Research by Jones Lang La Salle shows that changes in capital values and tenant demand typically lag the economy by one to three years. So while there may be signs of life in the stock market (a leading indicator) that is no help to real estate. Real estate lags because leases are relatively long term and tenants (unless in bankruptcy) can not terminate commitments until the end of the lease. The inability to terminate early coupled with the physical and economic constraints of sub-leasing, results in a "phantom vacancy" that does not show up in vacancy rates for years.

Real Estate Fundamentals

All real estate fundamentals are negative. The economy is weak, therefore demand for space is weak. Employment drives demand for all types of real estate both commercial and residential. Employment is still declining (although the rate of decline appears to be easing). Unemployment in California is now 11%.

It could be worse – new supply is relatively constrained unlike the early '90's when most markets were not only over built but still completing large numbers of new buildings.

The main criteria for a buoyant real estate market is availability of capital; currently there is almost no capital available. When capital does return it will be more expensive as a result of pricing risk more accurately.

As a result cap rates have increased dramatically and rents have moved much lower.

The Moodys REAL Index has fallen 35% since its peak in October 2007 (over 16% in May and April alone). This compares with residential values which according to the Case Schiller Index have only (!) fallen 30% from its peak in June 2006.

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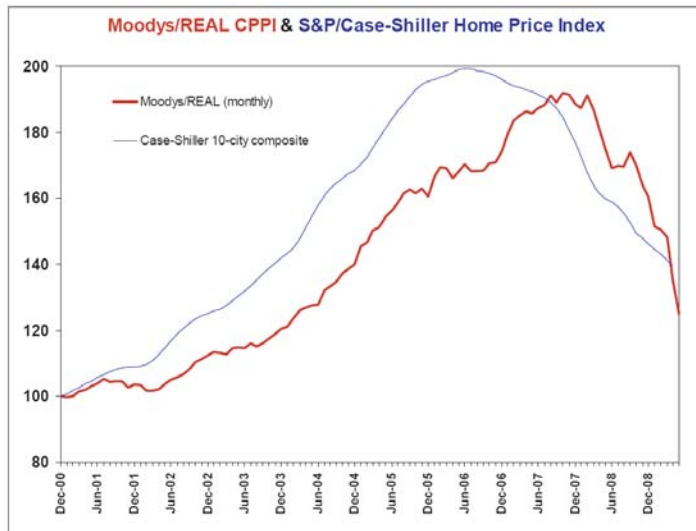
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The following table compares the decline in commercial real estate values with home prices.



The Banker's Dilemma

So what is a banker to do? The consensus at the moment appears to be 'kick the can down the road'. Bankers confronted with maturing loans that can not be refinanced in today's world are negotiating short term extensions. Understandably the banks know that if they foreclose they are not well placed to handle the asset and will end up taking a significant loss. If they hold on things may be better in 18 months or 2 years. Or will they?

The economy should be in better shape by then (if not we really are in trouble). The real estate cycle will have moved further towards recovery; probably true. There will be more capital available; hopefully the markets will have figured out how to create some liquidity by then. BUT real estate lags by one to

three years and if we have not seen a bottom yet? Figure in the huge number of loans with a 2010 - 2012 maturity that will require tremendous capital to refinance.

Consider that we are probably in the throes of a global recession second only to the Great Depression. Clearly there are structural shifts underway - for example the new found frugality of the US consumer who single handedly for the past ten years has been responsible for 20% of global GDP.

To Extend or Not to Extend?

So should those loans be extended? Well, it all depends. It depends on the specifics of each property. It makes sense for the lender to avoid foreclosing only if there is a reasonable chance that time will make a difference. If the property is fundamentally stressed under any likely scenario then better to bite the bullet now and deal with it. To be fully informed the lender needs to understand the real estate intrinsic of the asset not just of the loan - what are the dynamics affecting that particular sub market, that particular group of tenants, that particular group of leases. Those are judgment skills that banks typically do not have in house. The automatic reaction of a lender faced with these issues is to call for an appraisal. A good appraisal will tell a lot about a property but not what a lender truly needs to know to make these critical decisions because an appraisal is by definition largely based on historic facts i.e. properties that have sold when what is needed is exactly the opposite - a researched analysis leading to a professional opinion of what is likely to happen in the future.

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Be Proactive

The standard advice for borrowers is to get out ahead of an impending problem and talk to the lender. We think the same advice holds good for lenders – be informed and knowledgeable about the asset and understand how it is likely to perform under different scenarios over the next couple of years.

Identify the key issues affecting value. The biggest single issue affecting values, particularly at this stage in the cycle, is tenancies and specifically tenant retention. The cost of replacing a tenant is huge – tenant improvements, commissions, free rent and lost rent. If a lease can be renewed ahead of expiration and it requires capital for improvements or other incentives then figure out a way to make it happen!

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is pleased to announce his appointment as

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About Campus Property Group

Campus Property Group principals, Robert Upton and Michael Hooper, have both been real estate professionals for over thirty five years. Their hands on experience includes building, managing, leasing, financing and selling office, retail, industrial properties as well as both multi family and single family residential. They have advised a variety of clients on real estate matters including lenders, individual owners, public companies, international investors and the UK government.

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