Spring 2009 Newsletter

By Bob Canter, Managing Partner

Is this just the beginning of a long downward spiral or as some have suggested we are near bottom? The commercial real estate market is heading towards one of the worst crisis' it has ever experienced. All empirical evidence suggests there is no other conclusion that can be drawn.

Commercial Property Faces Crisis

The Reality of the Commercial Real Estate Market

The statistics that are pointed out in the referenced article bear out the upcoming calamity which will beset the commercial real estate sector on every level. As stated in the the article...“Partly because the commercial real-estate debt market is nearly three times as big now as in the early 1990s, potential losses in dollar terms loom larger.” As the article further points out of the approximate $6.5 Trillion value of the commercial real estate sector nearly 50% of that is encumbered by debt. The article points out the how the banking industry has risked so much “Tier 1” capital tied to commercial real estate, that a continuation of the banking crisis is inevitable.

The article further points out how owners will be hard pressed to re-finance their soon to be expiring mortgages. Even performing mortgage loans will be hard to refinance if the equity levels are too low given the reduced value of the property.

Many pundits including the current administration are claiming all the new stimulus money and band-aids the Government is applying will kick start the overall economy and help unfreeze the credit markets. Nothing could be further from reality.

Having talked directly with many bankers, many of whom are smaller regional banks, the problem which no one is taking into account, including our Government, is the banks are not going to go back and lend the way they were in 2002-2007. That means fewer borrowers will qualify under the stricter loan underwriting standards, collateral property values have dropped significantly, lenders will require more cash/equity which is in short supply by the average investor, the buildings themselves will show reduced NOI's (Net Operating Incomes) across the board due to the higher vacancy rates that are just now becoming reality. This is not even taking into account the number of recent investment purchases done in the last 3-4 years at ridiculously low cap rates with no due diligence, no real exit strategy, and no provisions for the traditional underwriting off-sets of 5% vacancy etc.

Add to the above new claims for unemployment benefits last week rose to a seasonally adjusted 652,000 from the previous week's revised figure of 644,000, the Labor Department said Thursday 3/26/09. The total number of people claiming benefits jumped to 5.56 million, worse than economists' projections of 5.48 million, a ninth straight record and **the highest total on records dating back to 1967.**

The Commerce Department said Thursday 3/26/09 that the economy shrank at a 6.3 percent annual pace at the end of 2008, the worst showing in a quarter-century, and a bit faster than the 6.2 percent drop estimated a month ago.

But many economists project the economy is contracting in the current quarter at a 5 to 6 percent pace, still very weak by historical standards, but slightly better than the end of last year.

What does all this mean...well since vacancy is directly tied to the unemployment rate, it does not take a math major to realize commercial properties are being emptied out and as we approach an even higher unemployment rate as experienced in the early 1990's...this current downturn will make the early 1990's look like a cake walk.

The commercial real estate market took a good 4-5 years to recover in the early 1990's and it should be anticipated this episode will take longer. You can not expect the economy to recover from this seismic shift quickly. You can not believe the economists who are predicting the end of this downturn now to be in 2010 or sooner. Considering their track record as a group, you'd be better off getting a witch doctor to predict the economic future. Economists don't ever take into account the emotional side of the economy, meaning how much people have negatively reacted to the current circumstances and changed the way they live and spend. You are not going to get people sending enough after their house values have plummeted by 30%-40%, their retirement and college fund accounts have been decimated by 40%-50%, and perhaps been laid off and have no income other than unemployment benefits. People are saving and reducing their debt loads like never before, which is a good thing but not for the retailers and the owners of retail real estate.

Therefore the only conclusion is the commercial real estate market is in for a long depressing time for the foreseeable future, whatever that may be. Do not delude yourselves in thinking the mess we are in can be cured anytime soon.

"We tell our clients what they need to hear not what they want to hear"

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