

## **The State of the Commercial Real Estate Finance Market ...?**

**Seth Bakes, President, Bakes and Company, LLC**

What is the state of the U.S. commercial real estate finance market? Good question. The short answer is that I don't really know. We are in new territory now and I don't know how to characterize it succinctly or even make good sense of it for that matter. Slow improvement? Transitioning to a healthier market maybe? Unresolved problems certainly.

Two strategic factors to consider are that there are currently historically high levels of extended, restructured, and delinquent non residential loans and historically high levels of commercial mortgage maturities in the next several years. This situation raises concerns about many things, one concern is that there are still many troubled banks; another is the effect this will have on lending activity.

Looking at things from a more positive standpoint, another major strategic factor is that interest rates remain at historically low levels: recently 10 year US Treasuries were 3.35%, 3 month LIBOR at 0.30%. This makes loans more affordable and encourages new borrowing and refinancing.

There is anecdotal evidence to support improving capital markets and higher levels of lending. One major real estate investment finance intermediary tells me that their origination volume was much higher in the second half of 2010 than in the first half. They suggest that 2010 is a turning point with 2011 being a year of recovery. Their production totals in 2010 were concentrated in permanent mortgages for apartments (and to a much lesser extent office), placed with Fannie Mae, banks, and investment banks. Very little production volume in construction loans, mezzanine debt, and equity. Other sources indicate that the CMBS market is coming back. Good news.

Origination volume is still way off its peak however. Per the Mortgage Bankers Association, commercial / multifamily mortgage bankers' originations in Q2 of 2007 were \$352 bil. (the recent peak) compared to Q3 2010 - \$70 bil.

Regarding non-performing loans and debt maturities and their effect on debt markets, industry catch phrases sound the theme that the banks are not pressuring their borrowers to repay loans as originally scheduled and as such banks are not aggressively cleaning up their balance sheets. Catch phrases such as "extending and pretending" and "a rolling loan gathers no loss" are common industry banter in the turnaround field.

But, bank special assets officers tell me that their inventory of problems is lower now than in the first half of 2010 and 2009. Perhaps this view is aided by the relaxation of FASB 157 in 2009 which gave lenders latitude on how assets can be marked to market. And, some say loan quality problems are more typical now in regional and community banks rather than in the large banks. As I said, we are in new territory. At some point

banks may move from accommodation to resolution although I don't see an avalanche coming.

Another strategic factor in the real estate capital markets is that in recent years there were more types of capital providers (hedge funds and private equity funds, for example) in the market issuing many different types of securities from lower risk secured financings to higher risk mezzanine debt to preferred securities to common equity. I don't have statistics on these transactions so it's difficult to draw conclusions, but want to acknowledge the situation and recognize that there are large sums of unregulated capital that are not reported.

Getting back to low interest rates and debt maturities, low interest rates certainly help lenders and borrowers work things out more patiently as interest accruals do not grow as quickly as they would in a higher interest rate environment. And as commercial real estate values are currently low by historical standards lenders are more inclined to be patient with distressed situations in the hope that markets will improve and timing will be better for a sale or refinance next quarter or next year. As discussed above, the relaxation of FASB 157 helps lenders be more patient.

One successful private equity investor that I know suggested that buying opportunities in his opinion would be better looking forward as he felt that asset prices would improve thus encouraging sellers to release more product for sale. This idea would be supported by the financial intermediary's recent experience with increased origination volume. Better availability of capital = better prices = more transactions. They reinforce each other.

Macro-economic factors that may change or complicate the view of the capital markets are: the high U.S. unemployment rate, budget deficits and national debt, and the financial condition of foreign banks and governments. Just too complicated and uncertain for me to comment.

Lastly, keep in mind that there is no such thing as a real estate market. The condition of real estate and the availability of financing vary by product type and location. The state of the market and financing available for apartments in Manhattan will be different than that for condos in Florida and office space, retail space, and development land in Los Angeles, Chicago, and Honolulu. All will all have unique conditions.

### **About The Author**

Seth Bakes is the President of Bakes and Company, LLC, a management consulting firm that specializes in real estate matters: performance improvement, turnarounds, and financial advisory. Seth is a member if the Philadelphia Chapter of the Turnaround Management Association and can be reached at (215) 527-5711, [Seth.Bakes@BakesandCo.com](mailto:Seth.Bakes@BakesandCo.com) , [www.BakesandCo.com](http://www.BakesandCo.com) .

***This article reflects opinions and judgments that are subject to error and change. Do not rely on this article for the purpose of making decisions including lending, investment, operational, or personnel decisions. Instead make independent inquiries and independent evaluations based on the specific circumstances of your situation.***

No part of this article may be reproduced in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the author.