

Where is The Commercial Real Estate Market Headed?

As George described in September Pipeline article, "A Tale of Two Markets," there are two views of the DC real estate market. Under the glass is half full view, the market is quickly returning to its old days of high values and significant velocity. Under the glass is half empty view, there is trouble ahead. While we tend to think the latter scenario is a more accurate reading, we do believe that a number of market factors will result in a substantial increase in commercial real estate activity over the next two years.

The National Landscape

The Moody's REAL Commercial Property Index reported August prices fell 3% from July and that prices have dropped 40.3% since August 2007. Sheila Bair, Chair of the FDIC, reported in mid-October to the Senate Subcommittee on Financial Institutions that "the most prominent area of risk for rising credit losses at FDIC-insured institutions during the next several quarters is in [commercial real estate] lending." This echoed Ms. Bair's statement in September that commercial real estate loans are a "looming problem." According to a report by Delta Associates, nationally, distressed commercial real estate (including properties in foreclosure, bankruptcy, restructurings, and those held as lender REO) reached \$114.2 billion in August, up from \$97.4 billion in early June. (Washington Business Journal Blog *Breaking Ground*, August 25, 2009).

There are many reasons for the gloomy reports but in our view the largest impediment to a "recovery" in the office building market is the "bid" and "ask" spread. The bottom may have been set in many residential markets due to the spate of single family house foreclosures and the \$8,000 federal income tax credit for first time home buyers. This contrasts with the office buildings which remain difficult to value, with owners (including REO held by banks and special servicers) unwilling to acknowledge the almost 41% drop in pricing and prospective buyers unwilling to pull the trigger on acquisitions.

Will the Bid-Ask Spread Narrow in the DC Market?

Although the performance of commercial real estate in the Washington, D.C. region, particularly the District of Columbia and close-in suburbs, is substantially better than in the rest of the country, this market has had its share of foreclosures and problem assets. The saga of the Watergate startled many when there were

no bidders at its July 21, 2009 auction where bidding began at \$25 million. PB Capital Corp., with a \$40 million note, took back the property. In April, General Electric Credit Equities took back title to Monument III, a 193,000 square foot building at 12930 Worldgate Drive. Approximately \$51 million was owed on the note at the time of the foreclosure. In May, Principal Life Insurance Co. foreclosed on 203,000 square foot Lincoln Park III in Herndon. Also, there has been more activity in the note sales arena, including the recent sale by Capmark of a note secured by the old CVS site at 7th and H Streets, NW.

These foreclosures and note sales stem from a simple set of facts. A huge number of loans are set to mature in 2010 and each year thereafter through 2013. Delta Associates predicts maturities will reach \$300 billion per year in 2012 and 2013. ("Report: Distressed Real Estate Totals \$97.4B," *Washington Business Journal*, June 23, 2009). At the same time, the real value of assets continues to decline. Net operating income of most properties continues to drop as lease rollovers in a tenant dominated market result in declining rents (ranging from 1.7% in Virginia, to 2.8% in the District to 5.7% in suburban Maryland). ("D.C. Office Vacancies Lowest in Nation," *Washington Business Journal*, October 7, 2009). And, many property owners are unable to replace existing tenants because of increasing vacancy rates (hovering, according to Reis Inc., as of early October at about 10.5% in the District and 14.5% in the Maryland and Virginia suburbs). This analysis does not even take into consideration the impact on values of a negative change in cap rates which as noted in the previous article have increased by a minimum of 150 basis points.

Thus, the maturity of commercial loans in DC looms as a growing problem that must be confronted in the next several years. This problem is exacerbated by the financial markets. There is no CMBS market. In the years before this financial crisis began loans typically were made at 80% loan to value (or at a higher leverage) whereas today, new loans, where they can be found, are generally closer to 50-65% loan to value.

A very simple example illustrates the problems confronting our market. An office building was acquired at a price of \$100 million in 2006. The buyer borrowed \$80 million on a five-year note. Assume that this property has declined in value by 30% (a reasonable

continued on page 20



George Covucci,
Partner

Arnold & Porter LLP



Amy B. Rifkind,
Counsel

Arnold & Porter LLP



WHERE IS THE COMMERCIAL REAL ESTATE MARKET HEADED? continued from page 3

assumption in the District but not in many in other jurisdictions where values have likely fallen even further). The property is now worth \$70 million—or \$10 million less than the amount owed on the loan. Even if the building is still fully leased with rent paying tenants, a new lender is unlikely to refinance the loan for more than \$45 million (65% of its current fair market value). Our hypothetical property owner, who initially invested \$20 million (now worthless) must cover a \$35 million dollar delta through an infusion of new equity to refinance the property.

Equity From Out of Town

There remains some promising news in our region. Skansa USA's recent purchase of PN Hoffman's project at 10th and G Streets, NW, may, in fact, result in the construction of a building that has been on hold since October 2008 when Hoffman's equity partner walked from the project. Vornado Realty Trust's recent sale of 1999 K Street, NW to Deka Immobilien GmbH for the headline worthy price of \$830 per square foot has everyone hoping that the market might be back.

There is little doubt that the DC market is better than almost all others. At the 12th Expo Real conference in Munich held in early October, DC brokers were told that "DC is the number one target right now" replacing New York as the focus for foreign investors. ("D.C. Still Focus For International Commercial Real Estate Investors," *Washington Business Journal*, October 15, 2009)

The recent sale of 1099 New York Avenue for \$90.5 million or \$517 per square foot to an investment fund of Credit Suisse adds further credence to such interest. Nevertheless, serious issues remain. First, interest remains focused on Class A properties in downtown DC. Offer a property outside of that class and location and there is a lot less, if any, interest. Second, all of these deals, from Skansa to Deka to Credit Suisse were purchased without debt by foreign investors. There is a huge appetite for trophy properties in DC and cash buyers lurking, but these opportunities represent a small part of the market here. The remaining segment of the market will remain dormant until there is a narrowing of the bid and ask prices. It appears that the spread between the prices fetched by trophy assets and the remainder of the market will continue to climb.

As it appears that in the foreseeable future the acquisition market will not bail out problem assets, nervous owners must consider their options.

Everybody's Talking, Except Lenders With Borrowers

Against this backdrop, many borrowers have been proactively approaching their lenders to figure out a plan for moving forward prior to a loan default or maturity. All of us have heard the refrain: "How do I get a special servicer to return my calls?" That query, however, has not been limited to CMBS loans. Borrowers with traditional loans have been having the same experiences trying to engage with their lenders. Thus far, lenders have been reluctant to engage with defaulting borrowers, preferring, where at all

possible, to allow the borrower to remain in the property and continue to service the monthly loan payments. Lenders have turned a blind eye to the value of the underlying property. The reason for this approach is simple: once a lender acknowledges that a property is substantially underwater or that a loan is unlikely to be repaid or enters into a loan modification that effectively recognizes the same, the bank needs to recognize the loss on its books or increase its loan loss reserves. Thus, as loans continue to mature and if there are defaults at the high rates anticipated by many, banks will be confronted with the hard choice of writing off the bad loan or keeping it on the books and increasing the bank's reserves—neither of which are appealing choices. And the stakes are high for banks. Indeed, according to Deutsche Bank analysts, U.S. banks hold more than \$1 trillion worth of mortgages backed by commercial property, on which, banks could lose as much as \$150 billion from foreclosures and note sales of troubled assets.

Regulatory pressure on bank lenders, however, may soon make lenders more realistic about real property values. FDIC Chair Sheila Bair noted in her October speech that federal banking agencies will be issuing guidance on commercial real estate workouts soon as they understand that lenders and borrowers alike "are frequently dealing with diminished cash flows and depreciating collateral values. Prudent loan workouts are often in the best interest of financial institutions and borrowers, particularly during difficult economic circumstances and constrained credit availability." Once banks are forced to recognize losses, the rest of the market will no doubt be brought along and the bid/ask divide will be narrowed significantly.

Money Talks or You Walk

Those who have entered into discussions with lenders have heard the same thing: come with a plan and come with dollars. Arguments that the owner has been a good steward of the property and that a lengthy loan extension will solve all issues do not buy much these days.

In this climate, borrowers must think strategically and realistically assess the current value of their properties and develop conservative *pro formas* of subsequent performance. With this analysis in hand, there are some options. One is to try to right size the loan by paying down a portion of the loan. The question will be where does the new money come from? Finding a new equity investor is difficult. So, the only alternative may be for the borrower itself to pay to play. This may be the correct solution, particularly if the lender provides reasonable terms for right sizing and extending the term of the loan and the borrower is able to defer tax recapture. Unfortunately, all too often, the bid and ask spread in the marketplace plays out in the context of a loan restructuring. Where there is a gap in value, we have been advising that a loan bifurcation (an A note set at conservative current value, with remaining loan balance after a curtail in the form of a B note, subordinate to new equity) might be the best approach. This structure allows the borrower to infuse new cash and receive a market return on this equity, but provides the lender with a chance to recoup all or a

portion of its B note if market conditions improve. With increasing regulatory pressure to recognize the real value of their assets, we think banks will be increasingly likely to engage in such restructurings. Any borrower considering such a strategy, however, must consider carefully the potential tax implications of the structure.

We believe that the most likely trigger for increasing the velocity of sales in the commercial market and narrowing the bid and ask spread is leasing risk and cost. The quandary that borrowers are facing now is whether to put more money into their property for tenant improvement allowances and brokerage commissions. Once a property is underwater (depending on how far underwater), these additional payments may simply make no sense. This situation also creates an immediate excuse for a dialogue between the borrower and lender as the decision on leasing, in addition to requiring fresh capital may have a significant impact on current and future value of the property. Borrowers will be reluctant to put in new capital without a re-sizing of the loan and situations where new capital is not available from the borrower, there may be a "forced sale" of the property.

What Will the Future Hold?

In summary, we believe that the dynamics of the marketplace over the next few years may create a new paradigm for values and sales. Maturing loans, capital infusions needed to meet releasing costs, and regulatory pressures on lenders should all play a part in forcing the marketplace to deal with the valuation issue and help to re-set values at more realistic levels. There is significant investment capital poised to buy, but today it is parked on the sidelines. Not all of it is foreign money. Much is local. As noted, the primary issues stalling the sales market are that purchasers and sellers have a very different view of property values and lenders have avoided to date acknowledging that, in many instances, their debt is worth less than the underlying property. Until that gap is filled, owners of properties will need to be creative, nimble and very careful in assessing current values and future performance. No new dollars should be spent on problem assets without a realistic consideration of all alternatives.

Though the country still has significant issues to resolve—unemployment levels, falling property values and lack of credit are just a few—there is a brighter future. Sales velocity will increase, albeit at lower prices. Lenders will be forced to engage with borrowers, resulting in workouts and foreclosures. Buyers lurking on the sidelines should find better opportunities at more realistic and lower prices. With all of that, the market is likely to begin functioning again. However, owners who bought in the last five years will face very difficult times as loans mature and declining rents and increased vacancies may result in forced sales and very difficult decisions on when and how to deploy new capital to protect their investment. (Please take these predictions, however, with a grain of salt as Amy was certain that the Red Sox would win the World Series this year and George predicted a 10-6 season for the Redskins.) ▲

NO PAUSE IN REGULATORY INITIATIVES

continued from page 9

construction. DCBIA pointed out some technical issues with implementation and suggested the need for some kind of reasonable cap on total fees levied by the PIF program. DCBIA anticipates further dialogue with DDOT on issues of concern through follow-on meeting(s) in the near future.

Green Building Legislation

Bill 18-377, the "Green Building Technical Corrections, Clarification and Revision Amendment Act of 2009," introduced earlier at the request of the Mayor (presumably DDOE), is now being revised for re-introduction by the Committee on Government Operations and the Environment. DCBIA will prepare testimony to address technical issues related to the requirement for Energy Star bench-marking of public and private buildings. DCBIA is also drafting a proposed amendment to the Green Building Act of 2006, which would provide a refundable compliance fee as an alternative to the impractical performance bond now required by the act.

Tenant Bill of Rights

Councilmember Muriel Bowser, Chair of the Council's Committee on Public Services and Consumer Affairs, has introduced Bill 18-484, the "Tenants Bill of Rights Amendment Act of 2009." The legislation directs the Office of the Chief Tenant Advocate to prepare a tenants bill of rights document which would accompany all leases for rental housing. Civil penalties are provided for failure of property owners to comply.

CBE Assistance Legislation

Councilmember Kwame Brown has introduced Bill 18-433, the "Small Business Stabilization and Job Creation Strategy Act of 2009." The legislation directs the Department of Small and Local Business Development to organize and conduct a program of training and related advisory services to assist CBEs, including the establishment of a "Volunteer Corps of Executives and Entrepreneurs" to provide mentoring and consulting services.

Business Organization Law Re-Write

Councilmembers Muriel Bowser and Mary Cheh have introduced Bill 18-500, "District of Columbia Official Code Title 29 (Business Organizations) Enactment Act of 2009." The legislation represents a comprehensive re-write and re-statement of those DC Code provisions regulating all forms of business organizations through which for-profit and non-profit entities operate. DCBIA is considering its response(s) to this measure as its effects will be felt throughout the development and more general business communities. ▲