If You Thought the Housing Meltdown Was Bad…

By Doug Hornig, Senior Editor, Casey Research

…wait until you see what's in the cards for commercial real estate.

That's right, the next train wreck will be in commercial real estate. Couldn't be worse than last year's residential market crash? That remains to be seen. But it's coming soon, probably as early as the second quarter of next year, and there's nothing that can prevent it. The government will intervene, trying desperately to delay the day of reckoning, and may even succeed. For a while. But make no mistake about it, that train is going off the tracks no matter what.

Every part of the sector – from multifamily apartment buildings to retail shopping centers, suburban office buildings, industrial facilities, and hotels – has accumulated a huge amount of defaulted or nonperforming paper. It's an impossible, swaying structure that cannot long stand.

Just ask Andy Miller.

Andy is one of the most knowledgeable people around when it comes to commercial real estate. Co-founder of the Miller Fishman Group of Denver, he has spent twenty years buying and developing apartment communities, shopping centers, office buildings, and warehouses throughout the country. He's also worked extensively – especially lately – with asset managers and special servicers (those who handle commercial mortgage-backed securities, or CMBS) from insurance companies, conduits, and the biggest banks in the U.S., advising them on default scenarios, helping them develop realistic pricing structures, and making hold or sell recommendations.

It isn't easy. Commercial real estate sales are off a staggering 82% in 2009, compared with 2008, and last year was worse than '07. No one is selling at depressed prices, but it hardly matters as there are no buyers, either because they're afraid of the market or can't meet more stringent loan requirements. Two years ago, the value of all commercial real estate in the U.S. was about $6.5 trillion. Against that was laid $3-3.5 trillion in loans. The latter figure hasn't changed much. But the former has sunk like a bar of lead in the lake, so that now between half and two-thirds of those loans will have to be written down, Andy estimates.

"If the banks had to take that hit all at once, there wouldn't be any banks," he says.

And it's actually worse than that. As even average citizens became aware during the subprime meltdown, loans in recent years were bundled into exotic financial vehicles that could be sold and resold, a class generically known as *conduits*. These commercial mortgage-backed securities, while less well known than their cousins built upon home loans, are nonetheless ubiquitous.

Three guesses who were among the significant buyers of CMBS. If you said banks,

banks, and more banks, you got it. Thus these folks are sitting not only on their own malperforming loans, but on a whole lot of everyone else's toxic junk, too.

This is how bad conduits are: A 3% default rate last year jumped to 6% in 2009 and is expected to double again, to 12%, in 2010. An entity that takes a 12% hit to its portfolio – and this includes countless banks, pension and annuity funds, international institutional investors, and others – is in deep, deep trouble.

The real tsunami is coming, probably in the second quarter of 2010, Andy estimates. Because that's when banks will have to start preparing for the wave of mortgages that were written near the market top and are maturing in 2011-12. Unlike home loans, commercial loans tend to be relatively short-term in nature (average 5-7 years), because – outside of apartment building loans backed by Fannie or Freddie – there are no government programs to subsidize longer-term ones. These guys mature in bunches.

According to a recent Deutsche Bank presentation, the delinquency rate on commercial loans as of the end of 2Q09 was greater than 4%. Of these, they expect that north of 70% will not qualify for refinancing. Imagine what will happen to the estimated $2 trillion in commercial mortgages that mature between now and 2013.

And even that is not the end of it. There's a second huge wave on the way in 2015-16.

Problem is, instead of trying to meet this inevitable challenge head on, asset managers have decided to believe in such phantoms as the tooth fairy, honesty at the Fed, and an economic turnaround powerful enough to bail them all out. De Nile is not just a river in Egypt.

To be fair, it's difficult to envision what an intelligent, aggressive response would look like, given the breadth and depth of the crisis, and the lack of resources available to deal with it. Miller recently met with a group of asset managers from a number of different, prominent banks. They reported that they're completely overwhelmed and can't even begin to cope with the sheer volume of problem loans on their calendar. It's so bad that they're *now* dealing with some borrowers who haven't paid a cent in a year and a half.

What do you do if, as Andy thinks is the case, 85-90% of the entire commercial real estate market is under water relative to its financing? What happens to a property when its value drops way below the loan, a seller can't get enough money to get out, a buyer can't raise enough money to get in, and the bank can't afford to foreclose? Simple. It just sits there, carried along on the bank's books at some inflated "mark to fantasy" price that makes the institution's balance sheet look passable. The industry even has a catchphrase for the situation: "A rolling loan gathers no moss."

In the case of a retail store, a bankrupt tenant walks away. Andy looked at just the part of Phoenix where his firm does business and found 90 vacant big box stores, with an aggregate floor space of 8 million square feet. If Christmas season is as lackluster as cash-strapped consumers are likely to make it, there will be many others to follow.

The hotel business is terrible. Overbuilding based upon travelers who went into debt to finance lavish vacations is taking its toll on tourist destinations. At the same time, business travel has seriously contracted. Flights into Las Vegas, which caters to both, have been slashed so much that even if every seat on every remaining flight were filled and visitors stayed for an average number of days, the hotels still couldn't break even. In industry parlance, banks are now engaged in "extend and pretend," i.e., giving hotels three- to six-month loan extensions in the hope that things will somehow improve in the near future.

Office space is doing okay in central business districts, but not faring well elsewhere. Some estimates tab the national office vacancy rate at over 16.5%, compared with 12.6% in January 2008. It exceeds 20% in parts of Atlanta and San Diego, and in many places in between.

Multifamily apartment buildings – and the very creaky Fannie and Freddie are carrying a load of them – may be the next to topple. As values deteriorate and landlords are faced with loans coming due, there is no incentive to fix whatever goes wrong. If, for example, you have a $10 million loan maturing in two years, and the property value has declined to $6 million, why would you spend half a million to fix leaky roofs? The question answers itself. Yet, as capital spending needs are not attended to, the apartments deteriorate. Which leads to working-class tenants replaced by meth labs. Which leads to even lower property values. And so on. In the end, when the banks are forced to take possession, they will be left with either expensive repair jobs, or the cost of demolition and a total write-off.

As the overall commercial real estate crisis escalates, the banks will do the same thing they did last year: run to the government, palms outstretched.

How will Washington respond? Good question. On the one hand, further bailouts will further infuriate the public. But on the other, the political sentiment will be that allowing the banks to fail will have even more dire consequences.

The Fed has already tried to let some of the relentlessly building pressure out of the balloon through TALF (Term Asset-Backed Securities Loan Facility). But that hasn't worked, because TALF only backs the most senior, creditworthy bonds in a CMBS pool. Those aren't the problem. The problem is the junior notes no one wants.

In order to increase market liquidity and get conduits moving again, the government will likely be forced to create a guarantee program similar to the FHA, Miller thinks, whereby short-term money (on the order of 5-7 years) is made available. Will that just push our problems five to seven years down the road? Quite possibly. But what is being purchased is *time*, the only thing left to buy. The hope, of course, is that it's *enough* time – for the real estate market to stabilize, prices to return to more "normal" levels, and the world to turn all hunky dory.

Rock, meet hard place. Let all the troubled banks fail, and the consequences will range from some excruciating but short-term pain, to a plunge into full-bore depression. Prop them up with yet more newly printed fiat money, and anything from high to hyperinflation will inevitably result, along with the possibility of extending the problem well into the next decade.

Both are frightening prospects. We don't want either, but realistically, we're going to get one or the other. Let's be clear, it won't be the end of the world. However, it will be the end of the world as we know it. That makes it imperative to prepare for the new one that's coming.

The editors of **The Casey Report**, supported by real estate pro Andy Miller, have been warning of the coming commercial real estate debacle since September 2008. This one's rather easy to time – because they know when the loans will come due. And as subscribers can testify, accurately predicting big trends is the forte of Doug Casey and his expert team. To learn how you can profit from making the trend your friend, click here.