Sperry Van Ness
Southern Commercial Real Estate

Recessionary Strategic Planning for Commercial Real Estate Professionals

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As I speak with clients, co-workers, and industry pundits, the one thing we all agree upon is that the economy is bad, and that we haven't found the bottom yet…especially where commercial real estate is concerned. While opinions may vary as to exactly where the market is headed, and the timing surrounding any major shifts in direction, everyone reading this paper understands one thing; the markets are fluid, evolving, and ever changing. Therefore the conundrum that those in the practice of professional commercial real estate are faced with is how to best position their portfolio to minimize the risks associated with market uncertainty, while at the same time maximizing current and future returns.

In last month's article, and as a prelude to the text that follows, I shared some high-level philosophical thoughts on the value of creating a strategic asset management plan. In this month's piece I'm going to attempt to take guess-work of market prognostication out of the equation by not relying on a crystal ball approach. Rather I'll take a more granular journeyman's approach in providing advice on tactical direction based upon the actual data and events we know to be true…no hype, no rhetoric, just the facts.

What We Know

All of the recent financial data that has been released over the past several weeks has indicated that an economic recovery won't happen anytime soon. In a public speech last week, President Obama indicated that unemployment will continue to rise in the near term, and we all know that the trickle-down of rising unemployment does not bode well for commercial real estate. While most of the media attention has clearly been focused on the trouble in residential real estate markets, I feel the larger risk to the economy lies in the risks associated with defaults on commercial assets.

According to data provided by REIS, defaults and delinquencies on hospitality, retail, and office properties have more than doubled in the last six months alone. Even more disconcerting is that default rates for industrial and multifamily properties have increased more than 80% during the same period. It doesn't take a rocket-scientist to understand that this sudden up-tick in late payments and defaults has many observers feeling that the next shoe to drop on the economy will be a collapse of the commercial real estate market.

While the risk is still difficult to quantify, we do know that it is highly probable it was underestimated in the FED's recent stress test of 19 major banks. The results of the stress test released just a few weeks ago, projected that should the recession worsen, the losses from commercial real estate loans could hit $53 billion, or 8.5 percent of their overall loan losses over the next two years. We know that the government historically underestimates declines. This I believe is particularly true given that the stress test did not include the majority of the regional and local lenders, which hold a big chunk of the nation's $3.5 trillion commercial property loans on their books and who remain particularly vulnerable to further economic declines.

So how bad is the commercial real estate market really? In the bullet points that follow, I'll state the facts and you can draw your own conclusions:

- Approximately $1.3 trillion in loans on commercial properties will be coming due between now and 2013 (if you didn't see my recent video on this topic please click here *insert link to real estate real 4*);
- More than $270 billion in commercial property loans are expected to come due this year alone;
- According to Real Capital Analytics, nearly $73 billion worth of commercial real estate loans are in some level of current financial distress;
- A recent report by Deutsche Bank estimates that at least half the all commercial loans and two-thirds of those packaged and resold as securities, will not qualify for refinancing when they mature.
- Fannie Mae recently stated that apartment building loans that were at least 90 days past due almost quadrupled between December and March to a rate of 0.34 percent. As a result, Fannie Mae's credit-related expenses for apartment loans jumped to $542 million from $59 million at the end of last year.
- The market has experienced unprecedented commercial failures in recent months including the failure of Circuit City, Linens 'N Things, and General Growth Properties filing the largest bankruptcy in US commercial real estate history.

In a nutshell, the problem can be summarized by understanding that there is perfect storm in play as a result of the confluence of the following 5 factors:

1.) A recession
2.) A severe decrease in flow of funds
3.) A substantial decrease in operating income
4.) Increased vacancies
5.) A substantial decrease in valuations

These current conditions combined with tough new underwriting standards and tight money supply has eviscerated the refinancing ability of commercial property owners. However refinancing is just one issue…perhaps a bigger issue is that many properties are just not trading at numbers that sellers can stomach.

While I could probably fill several pages with depressing economic data surrounding mounting trouble in the commercial real estate markets, I don't see the need to belabor the point as the undeniable reality is that commercial markets are in trouble, and rapidly worsening. While there is great speculation that the FED will extend/offer additional assistance to commercial lenders to help offset mounting losses incurred by lenders, my concern is one of "good money after bad." The bailouts, subsidies, and unprecedented government intervention haven't stabilized the residential markets or the recessed economy, so why would any rational person believe these types of actions will resolve similar issues in the commercial markets?

What You Can Do

Don't panic…plan. The reality is that markets cycle, and while boom isn't always followed by bust, boom is ***always*** followed by some type of market retraction. While many drank the Kool-Aid of over exuberance created by the frothy market conditions of prior years, markets simply cannot sustain uninterrupted advances in perpetuity, and it's a fool's gambit to fall prey to this type of irrational thinking.

Prudent real estate professionals manage and monitor the balance of risk and opportunity on a consistent basis. They don't allow themselves to be whip-sawed by market volatility, or other changes in economic/financial conditions. Whether or not you believe there is an eminent collapse of commercial markets looming in the shadows, you must admit that market conditions have fundamentally changed. Therefore you must adapt your operating practices accordingly if you hope to minimize the damage to your portfolio, your investors, and your company.

I would encourage everyone reading this article to consider the following 5 suggestions for managing your way through to brighter days:

1. **Seek sound advice and counsel**: Analysis paralysis is not your friend. Rather than attempt to travel in uncharted territory, seek out intelligent people who have successfully blazed the trail before you. No single person has all the answers, and rather than finding yourself stymied by a lack of resources and/or information, I suggest you surround yourself with sound counsel, seek their advice, and then trust your instincts.
2. **Identify your risks and opportunities**: Immediately take stock of where you have the most risk and where you have the most opportunity…contrary to popular business theorists, they may not be one in the same. Evaluate portfolios and individual properties, asset classes, geographic markets, tenants, leases, lenders, investors, suppliers, and even staff. Assign your best talent to your biggest problems and your greatest opportunities.
3. **Speed is your friend**: Move fast…don't allow yourself to fall behind the curve of market conditions being relegated into a reactive position. Be proactive in your approach and drive changes via proactive leadership.
4. **Negotiate, Negotiate, Negotiate**: Realize that most of your stakeholders are feeling the same pain you are. This is the time to restructure leases, operating agreements, loan covenants, etc. Virtually anything is in play right now. Cut your deals from a position of strength, before you end-up negotiating against yourself from a position of weakness.

5. **Know when to hold 'em, and know when to fold 'em**: Once you've identified untenable risks, eliminate them immediately, and similarly, once you identify solid opportunities, exploit them immediately. Don't fear taking a loss if it protects the solvency of other assets or your enterprise as a whole. You can either stop the bleeding, or live to play another day, or count the days until you're just another casualty of the recession. The choice is yours…choose wisely.

My Biography

About Us

In 1996, Mark Mayfield and Randy Graham started in business together with Southern Realty in Rock Hill. Mark originally started Southern Realty's commercial division in 1991. Southern Realty was purchased by the Allen Tate Company in 1998 and together Mark and Randy purchased the Commercial Division in April of 1999 from the Allen Tate Company and started their own company – Southern Commercial Real Estate, LLC.

As principals of Southern Commercial Real Estate, LLC ("SCRE"), they have considerable experience in successfully selling and leasing all types of commercial and industrial property in the Upper Piedmont of South Carolina. Mark has over 18 years of experience and a career volume of $108 million in 400+ transactions. Randy has 15 years experience and a career volume of nearly $68 million in 200+ transactions.

With a successful track record and established entity, SCRE expanded its services and national reach on January 1, 2007. SCRE joined forces with a nationally recognized leader, and the fastest growing commercial real estate brokerage firm in the United States, Sperry Van Ness to form Sperry Van Ness/Southern Commercial Real Estate. Founded in 1987, Sperry Van Ness has over 1,000 advisors in the US and internationally providing advisory, brokerage, consultation, asset management, leasing, accelerated marketing and auction services.

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