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Commercial Property Recovers in U.S. as 'Tsunami of Distress' Fails to Hit

By Brian Louis and David M. Levitt - Feb 4, 2011

From [Manhattan](#) office towers to apartments in [Florida](#) to retail properties in [Washington](#), commercial real estate values are rising, defying predictions of a collapse that would drag the [U.S. economy](#) back into recession.

Prices of commercial properties sold by institutional investors surged 19 percent in 2010, the second-biggest gain on record, according to an index developed by the MIT Center for Real Estate. Investments in office properties, the largest part of the market, more than doubled last year to \$41.6 billion, according to [Real Capital Analytics Inc.](#), which tracks commercial property sales globally.

Near record-low [interest rates](#) are luring buyers with the prospect of cheaper financing and higher returns. Lenders are beginning to sell distressed properties and loans as rising earnings give them a cushion to absorb losses. Investors, convinced the worst is over, have pushed prices on commercial mortgage-backed bonds to the highest level in two years.

“Give a little credit to the strategy put forward by the government: keeping interest rates low and giving lenders some flexibility to hold these troubled assets on their books for a while,” [Dan Fasulo](#), managing director at New York-based Real Capital, said in a telephone interview. “Now that values are on the upswing, it’s given owners and lenders more wiggle room to work out these troubled situations.”

Conditions Stabilize

Market and credit conditions have leveled off and signs of price stabilization are emerging in several key markets, Patrick M. Parkinson, Federal Reserve director of banking supervision and regulation, said in remarks prepared for a hearing today by the Congressional Oversight Panel of the Troubled Asset Relief Program, created following the 2008 financial crisis.

“Nevertheless, while some directional metrics are improving, the commercial real estate market is still distressed and the strength and pace of improvements remain uneven,” he said. “Many banks with commercial real estate concentrations will continue to be under stress.”

While several banks will struggle, and continued delinquencies and losses will hinder economic growth, “we do not see commercial real estate losses as a threat to systemically important financial institutions,” Parkinson said.

Commercial real estate transactions may climb 40 percent to \$135 billion this year, Chicago-based [Jones Lang LaSalle Inc.](#), the second-largest publicly traded broker, said on Feb. 2. U.S. commercial real estate values, which fell 45 percent from the October 2007 peak to the trough in August 2010, have risen three consecutive months, according to Moody’s Investors Service.

Vornado’s Mall Deal

Those taking advantage of improving conditions include Vornado Realty Trust, which in December paid \$115 million for the \$171.5 million loan on its Springfield Mall in the Virginia suburbs of Washington, resolving a standoff with its lender. The loan had been transferred to a special servicer a year earlier because the New York-based real estate investment trust was in danger of “imminent default,” according to [Fitch Ratings](#).

In downtown Fort Lauderdale, Florida, a market damaged by declining home values, USAA Real Estate Co. bought Las Olas Centre, a 469,000-square-foot (43,600-square-meter) office complex that had been seized by lender [Wells Fargo & Co.](#) USAA Real Estate, based in San Antonio, paid \$170 million in September; the previous owner spent \$231 million near the top of the market in July 2007, according to Real Capital.

Delinquencies Slow

Last February, the TARP oversight panel said a deteriorating commercial real estate market had the potential to wreck the U.S. economy. The panel said in a report that almost half of the \$1.4 trillion in commercial property loans set to be paid off by 2014 were underwater, meaning the borrower owed more than the property was worth.

Unless refinanced, the debt “could threaten America’s already weakened financial system,” the report said.

While late payments on commercial mortgages bundled and sold as bonds increased to 8.79 percent in December from 4.9 percent a year earlier, the pace of growth in delinquencies is

slowing, according to Moody's. In 2011, the delinquency rate will climb less than in the past two years, the ratings firm said in a Jan. 12 report.

"That tsunami of distress that had been forecast has not really materialized," said Brian Stoffers, co-president, CBRE Capital Markets, a financing and investment sales division of Los Angeles-based broker [CB Richard Ellis Group Inc.](#) "The market's getting stronger."

Fundamental Improvement

As lenders renegotiate some loans and sell others, the danger of defaults triggering another recession has eased, said [Susan Wachter](#), a finance professor at the University of Pennsylvania's Wharton School in Philadelphia.

"Balance sheets are firming up, interest rates still are near historic lows and the fundamentals of commercial real estate are improving," Wachter said.

An expanding economy is helping boost the confidence of real estate investors. U.S. gross domestic product advanced at a 3.2 percent annual rate in the fourth quarter, the Commerce Department said Jan. 28. The U.S. office-market vacancy rate will fall to 17 percent in 2011 from 17.8 percent in the fourth quarter as employers add jobs and few new buildings are completed, according to an estimate by [Grubb & Ellis Co.](#), a Santa Ana, California-based broker.

A resurgent debt-securitization market is also driving the recovery. Commercial mortgage-backed securities issuance in the U.S. rose to \$10.9 billion in 2010 compared with \$2.1 billion in 2009, according to a Jones Lang report on Feb. 2. Issuance is estimated to be over \$40 billion in 2011, "providing added liquidity to owners with maturing loans to refinance," the report said.

Hot Cities

The biggest metropolitan areas, notably New York, Washington and Boston, are leading the recovery as employment growth and large inventories of well-leased, income-producing properties attract investors. [New York](#) commercial property prices rose 16 percent in the fourth quarter from a year earlier, while Washington gained 20 percent, according to the National Council of Real Estate Investment Fiduciaries, a Chicago-based trade group.

In the office market, prices in the top 10 cities jumped 30 percent in the third quarter, according to CoStar Group, a Washington-based provider of real estate data. Nationally, prices fell 7 percent.

Market segments including hotels, apartments and retail are also on the rise.

Hotels were hit hard by the recession, as businesses and consumers cut back on travel. A rebound started last year, with the average occupancy rate in the top 25 U.S. markets rising to 64 percent from 60 percent in 2009, according to [Smith Travel Research Inc.](#) of Hendersonville, [Tennessee](#).

Blackstone's View

The upswing is boosting hotel sales in the Americas, which are expected to jump as much as 25 percent this year, Jones Lang LaSalle's hotel investment-services unit said on Jan. 4. As property values rise, lenders are reworking existing loans and making new ones, according to Christopher Jordan, head of hospitality banking at San Francisco-based Wells Fargo.

"Hotels represent a very attractive investment opportunity because they've seen such a sharp decline," Jonathan Gray, senior managing director and co-head of real estate at New York-based [Blackstone Group LP](#), said during a conference on Nov. 18. "We've been deploying a lot of capital in this area."

Hotels have an advantage that other types of commercial real estate lack, said [Morgans Hotel Group Co.](#) President Marc Gordon. They can boost room rates quickly to take advantage of economic growth, while tenants at offices and retail properties tend to sign multiyear leases.

Rent Appeal

Sales of apartment buildings nationwide rose in the fourth quarter as home ownership remained at a 10-year low and demand for rentals pushed lease rates to the highest in four years, according to Axiometrics Inc., a Dallas-based research company.

Apartment rents climbed 4.31 percent in the last three months of 2010, the most since the third quarter of 2006, according to Axiometrics. The firm projects a 5.85 percent increase in U.S. rental revenue in the next 12 months.

The volume of apartment sales nationwide climbed 96 percent to \$33.7 billion in 2010 over a year earlier, according to Real Capital. December's dollar volume of \$6.1 billion in sales was the highest monthly total since October 2007, when Tishman Speyer Properties LP and Lehman Brothers Holdings Inc. completed the purchase of Archstone-Smith Trust, which at the time was the largest apartment real estate investment trust by value.

Retail Sales

The retail segment of the market is improving, though at a slower rate than offices or apartments. Transactions rose 51 percent to \$22.6 billion last year, according to Real Capital. In the fourth quarter, deal value averaged \$168 a square foot, up 30 percent from a year earlier.

Consumer spending rose more than forecast in December. Deutsche Bank Securities Inc. chief U.S. economist Joseph LaVorgna projected “continued healthy spending in 2011,” citing a “tame” inflation trend.

Of the \$52 billion of retail properties to fall into default, just over half have completed workouts, “giving the retail sector the distinction as the first property type to pass the halfway point in resolving its distress,” Real Capital analysts wrote in a January report.

A continued improvement in the market will help banks sell off additional bad loans.

Below the Peak

The recovery isn’t complete. The MIT Real Estate Center transaction index is 28 percent from its June 2007 peak. On an accumulated total return basis, which includes net income generated by the properties, the index is 16 percent below the high, the Cambridge, Massachusetts-based center said in a Feb. 2 statement.

Markets hit hard by the housing bust are struggling and are less likely to recover quickly, PriceWaterhouseCoopers LLP said in its annual Emerging Trends in Real Estate survey in October. Las Vegas, Milwaukee, St. Louis, Detroit and Cleveland are among the cities that scored the lowest in its poll of investors.

“Many secondary cities and most tertiary markets just do not appear on investor radar screens,” the study said.

James S. Corl, managing director of real estate investments at New York-based private-equity firm Siguler Guff & Co., said investors are crowding into the best-performing cities, betraying a lack of confidence in the broader market.

“What’s really going on right now is a classic [risk aversion](#),” he said in an interview. “Most people allocating money to commercial real estate are going after core deals” and “paying up for existing leases.”

Corl said this conservative approach means investors passing up the opportunity to make bigger returns. “Risk is very attractively priced,” he said.

Working Down Debt

Banks reduced the amount of soured real estate debt last year primarily through sales of loans, according to Matthew Anderson, managing director at Foresight Analytics, an Oakland, California-based research firm. The amount of nonperforming commercial real estate mortgages and construction loans at banks peaked in the first quarter of 2010 at \$126.2 billion. By September, the amount was \$115.7 billion, said Anderson.

“There’s still a large volume of nonperforming loans out there that still need to be dealt with,” said Anderson, who expects further declines. He is scheduled to testify today before the TARP oversight panel that raised concerns about defaults last year.

Large Numbers

Some of the deleveraging is occurring at places such as [Auction.com](#) in Irvine, [California](#). The company auctioned \$2.2 billion of notes in 2010, fetching 56 percent of face value, and it expects that to at least double this year.

“The numbers are so large,” said Kenneth Rivkin, Auction.com managing director, who described his company as an “EBay for properties.” “With real estate values down 40 percent nationally, there has to be hundreds and hundreds of billions” of distressed mortgages and properties poised to be sold. “If somebody has a good platform that has proven itself, their business should be up significantly.”

Carlton Group, a New York-based real estate investment bank that runs the Carlton Exchange listing service, closed loans with a principal balance of more than \$2 billion last year, and expects to do \$7 billion to \$8 billion this year, said Howard Michaels, the firm’s chairman.

Prices for the most sought-after properties in Washington and New York are approaching peak levels. Capitalization rates are falling as prices rise. The cap rate, a measure of investment yield, is calculated by dividing net operating income by purchase price.

Manhattan’s average cap rate on offices was 5.5 percent at the end of 2010, compared with 6.2 percent for central business districts nationwide, according to Real Capital.

Seattle, [Chicago](#)

As yields on properties in those markets tumble, investors are looking to other markets for higher returns.

Seattle, the San Francisco Bay area, suburban New York and Washington, and parts of Chicago and Atlanta will be among the next markets that see rising prices, according to Lee Menifee, senior

director of global strategy at CB Richard Ellis Investors in [Los Angeles](#). The affiliate of CB Richard Ellis has \$36 billion in assets under management.

“They’re getting interest both from lenders and investors,” Menifee said of these areas. “The confluence of those two things would suggest that there’s going to be a run-up in prices for high-quality assets in those next-tier markets.”

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