The Serious Commercial Real Estate Credit Crisis and GSA: Leasing and Building During an Economic Crisis

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Committee on Transportation and Infrastructure
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The current financial crisis and economic recession are dragging the commercial real estate sector into a very difficult business environment characterized by numerous negative trends, including the following:

Increasing vacancies
Falling rents
Dwindling development prospects
Lack of available capital for lending
Stricter underwriting and higher cost of financing
Falling property values
Sluggish investment and transaction markets
Increasing loan delinquencies and rising foreclosures
Growing distress for property owners

While these trends are bad for the commercial real estate industry, they present a somewhat more favorable environment for tenants, as the availability of space is increasing while rents decline. The current commercial real estate market is a tenant's market for those tenants looking for space.

Demand for commercial real estate is directly tied to the U.S. economy and job growth trends. The U.S. economy contracted 6.2 percent in the fourth quarter of 2008, and monthly job losses in excess of 650,000 have ravaged not only consumer spending and confidence, but also have impacted commercial real estate, especially office, retail, and industrial properties. The economy is expected to continue its decline through at least the first two quarters of 2009, with modest growth expected to return by the latter half of the year, according to the quarterly Survey of Professional Forecasters released February 13 by the Federal Reserve Bank of Philadelphia. Quarterly growth from first quarter 2009 through first quarter of 2010 is expected to be -5.2%, -1,8%, 1.0%, 1.8%, and 2.4%, respectively. On a year-over-year basis, growth is expected to be -2.0 percent in 2009 and 2.2 percent in 2010. However, there is little certainty about these expectations, and negative growth could well continue through all of 2009, given the current scope of the financial crisis and recession. The forecasters in the above survey see a 45 percent chance of negative growth in the third quarter of 2009, a 30 percent chance in the fourth quarter, and a 22 percent chance for the first quarter of 2010.

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Problems in the commercial real estate sector are still in the early stages of development, and this sector will likely see recessionary conditions well into 2010 and beyond. In fact the, overall economy is likely to begin recovering well before commercial real estate begins to recover. In general, the U.S. commercial real estate market faces continued downside risk in an extremely unsettled economic environment characterized by a global financial crisis, severe world recession, declining property values and fundamentals, and a crisis of confidence on the part of consumers, lenders, and investors.

Commercial Real Estate Fundamentals

Alls sectors of commercial real estate are currently in decline. Industrial properties will weaken in the consumer downturn as fewer goods are shipped and distributed. Hotels suffer as business and tourist travel is cut back in the recessionary environment. Retail properties are suffering as cash-strapped Americans struggle with credit card debt, the mortgage mess, and the gloomy employment environment. Businesses have stopped expanding or are downsizing, hurting office properties, with vacancies rising and rents falling. In general, vacancies are rising and rents are falling in all commercial property sectors.

Unlike the housing sector, which has been in recession for more than two years, the recession in the commercial real estate sector has only recently begun. In fact, the commercial real estate sector was extremely healthy throughout much of the early part of the decade, with relatively low vacancies, healthy rent growth, and strongly increasing property values. This situation began changing in late 2007 and strong deterioration began in the latter half of 2008. Because commercial real estate has been relatively late to enter the recession and typically lags the rest of the economy, the sector is not expected to enter a recovery stage any time soon, and any recovery probably will occur well after the housing sector and broader economy begin to recover.

Falling Revenues. Office vacancy rates in the U.S. have risen from 12.8% in Q4 2007 to 14.7% in Q4 2008, according to CB Richard Ellis. Other estimates from Property & Portfolio Research reveal even higher vacancy rates. Office leases typically run 5 years or more, which insulates the office market over the short run from sharp decreases in demand. However, vacancy rates are expected to continue increasing over the next year and perhaps longer, with some estimates of 18-20% vacancy rates by the end of 2010. Vacancy rates will be rising for industrial, retail, and apartment properties as well.

In addition, office rent growth turned negative in the latter part of 2008, and negative rent growth is expected to continue well into 2010 and probably longer, depending on how the economy performs. The lack of new construction will eventually lead to stronger rent growth in future years, as office space shortages could develop by 2011 and 2012.

Increasing vacancy and falling rents will translate directly into reduced income for commercial properties, which will put strains on operating budgets, reduce values, and create distress for owners.

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Dwindling Development. Commercial developers face a dismal year—financing has evaporated for new construction, demand is falling, and projects coming on line will struggle to lease up, falling short of forecasts. At least commercial development activity remained relatively tempered throughout the upcycle, helping many markets approach supply/demand equilibrium.

As of early 2009, construction and development in the commercial real estate sector is decreasing, and decreases in completions will be more precipitous in 2010 and beyond. By one estimate from Property & Portfolio Research, office completions in 2010 will total only about one third of the completions in 2008. Office completions are expected to remain at low levels until 2012. Retail and warehouse completions in 2010 could total less than 20% of 2008 completions. These trends are painful for the construction industry and the economy generally, but will lead to healthier commercial real estate markets in 2011 and 2012, with rents increasing again.

Commercial Real Estate Capital Markets

The **lack of liquidity** in the financial sector has been well-documented, and this problem is particularly severe for the commercial real estate sector, as it is a capital intensive industry that relies on mortgages and debt to finance both development and ownership of properties. Because of the financial crisis and problems on the housing side of the mortgage market, lenders and investors alike now have a greatly reduced appetite for real estate lending and debt of any type.

Late-in-the-game **investors** who heavily leveraged acquisitions at peak market prices face significant hurdles to meeting debt-service requirements as weakening tenant demand results in rising vacancies and slackening rents across most property sectors. Long-term owners, employing reasonable financing strategies, should manage their way through the downturn, suffering paper losses after significant gains over the past decade. Lender problems will extend from residential portfolios into commercial real estate loans, the consequences of shoddy underwriting as markets became overheated.

Perhaps most important for real estate capital markets are the problems in the **commercial mortgage-backed securities (CMBS)** market. CMBS issuance grew dramatically over the past ten years and as of early 2008 had come to be a huge source of debt capital for commercial real estate, with over $230 billion of CMBS issuance in 2007. However, there has been no new issuance of CMBS since the second quarter of 2008, and it is unlikely this critical source of commercial real estate debt capital will be revived any time in the near future. This is a serious problem for commercial real estate, as this capital source is not easily replaced in the current climate. Other sources of real estate debt capital, notably banks and insurance companies, have retrenched as well.

In addition to the lack of capital availability, **underwriting standards** have shifted drastically and the cost of debt capital has gone up. Interest rate spreads over treasuries have increased substantially. Loan-to-value ratios, debt coverage ratios, and required equity are now much more conservative. This has greatly inhibited the real estate transaction market, as the acquisition of real estate using debt and leverage strategies is now less attractive. More importantly, the refinancing of existing loans is now far more difficult, requiring more equity to make deals work.

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Moreover, **property values** have declined due in part to rising capitalization rates and a lack of investor confidence. **Cap rates** continue to increase closer to more historic norms, raising yield expectations and triggering depreciation. Real estate total returns in the NCREIF index were -8.29 for the fourth quarter of 2008, an extremely low number for this index, and further declines are likely for several more quarters. As of the end of February, equity REITs provided a -57.29 percent annual return for the year ending in February. Further severe declines are unlikely in the REIT sector, but any upside is hard to predict. Since 1) cap rates are rising, 2) debt capital is less available and more expensive, and 3) economic growth is expected to be negative at least through mid-year 2009, total returns on commercial real estate investments are likely to be under pressure for the foreseeable future.

As a result of all of these trends, **refinancing** of any commercial mortgage coming due will be extremely difficult for most property owners in 2009 and 2010. Many commercial real estate loans are structured as five-year loans, and thus for these types of such loans, roughly 40% of loans will be coming due in the next two years. Many of these borrowers will find themselves unable to obtain suitable financing, as any new financing sources will likely require more equity and charge higher interest rates than the borrower can manage, especially if the property's value has declined. As a result, many owners will find themselves in distressed situations, and will either lose the property to the lender or will sell the property at a distressed price level. This can and will happen even to owners with properties that are performing well, with low vacancies and solid rent rolls. This problem will not likely go away over the next year even if the economy starts to recover, and thus will severely impact a large number of commercial real estate owners, investors, and lenders that have used leverage to finance properties.

More generally, going forward investors and property owners will need to focus on **asset management** and leasing strategies to hold and attract tenants, managing costs and limiting declines in property cash flows. Once liquidity returns to credit markets, chastened lenders will continue to force stringent requirements on borrowers. Investors will need to reorient acquisition strategies away from high leverage and financial engineering, and expect more moderate returns in any recovery. Cash investors will have the upper hand and excellent opportunities will appear to buy at market lows and recapitalize struggling owners. Significant equity capital apparently waits for sellers to capitulate and owners to mark down portfolios. Optimists suggest the sidelined capital will be enough to cushion markets against a severe downturn. But many insist that resumed debt flows will be necessary to prop up markets and resuscitate transaction activity.

Beginning in 2010, anticipate a slow recovery in some real estate business sectors, hampered by risk aversion, constricted financing sources, and a weakened economy. REIT stock portfolios will likely lead any rebound. Resumed debt flows will be necessary to prop up markets and resuscitate transaction activity. Direct real estate investments will recover later and more slowly.

For GSA, the current environment presents both opportunities and problems. On the negative side, because of the lack of financing, it will be more difficult for developers to develop new buildings to meet specific GSA standards and requirements, although GSA is certainly a strong credit tenant for any proposed development deal. Moreover, the lack of new speculative buildings in the market, which tend to be more green and energy-efficient, will inhibit GSA's ability to find

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the most technically advanced green and energy-efficient space. However, the retrofitting of existing buildings to be more green and energy-efficient will proceed as owners seek to upgrade their buildings to compete in a difficult market that is increasingly demanding green building space.

On the positive side, availability and choice in office space markets is increasing while costs are decreasing, and the 2009-10 period will certainly be a tenants market. Rents and occupancy costs will decline or stabilize at attractive levels for several years. Thus, the next two years should be good times for leasing new space or renewing/renegotiating leases at attractive terms. Moreover, attractive acquisition opportunities will present themselves in a transaction market where there will be distressed sellers and few buyers. GSA could find attractive buying opportunities and could potentially acquire quality, well-located office buildings for its own use at greatly reduced prices. GSA could also strengthen its role as a catalyst to upgrade many older buildings to meet new green and energy-efficiency goals and standards.