Marcus & Millichap
RESEARCH SERVICES
THE OUTLOOK

Government Programs to Restart Commercial Real Estate Credit Flows Beginning to Show Promise

Executive Summary

Having weathered the recession with resilience throughout most of 2008, commercial real estate is now facing a dual challenge of rising vacancies and exceptionally tight debt financing. Both are largely the result of the escalation of the recession into a global financial crisis last fall.

Tangible results from government initiatives to stimulate the economy and loosen lending are modest at best; however, it is clear that government action helped to avert the worst-case scenario. Interbank lending has stabilized; investor and consumer confidence levels have moved off of recent lows; home sales are rising, albeit largely as a result of foreclosures; and aggressive cost-cutting is resulting in better-than-expected corporate profits. The U.S. economy and the availability of debt capital have a long way to go before returning to "normal," and many challenges remain. It appears, though, that conditions are improving and moving in the right direction.

Status of Government Programs: Pages 3-5

Term Asset-Backed Securities Loan Facility (TALF)

- TALF was expanded in May to include highly rated commercial mortgage-backed securities (CMBS). Spreads on AAA-rated CMBS have since narrowed dramatically.
- At its first subscription date in July, the legacy CMBS component of TALF received requests for $670 million in loans. All but one of the bonds submitted were accepted as collateral for TALF loans.
- Two REITs are expected to soon test the new CMBS component of TALF, with each projected to borrow up to $600 million against assets in their portfolios. A substantial amount of the capital raised will likely be utilized to pay down maturing debt.
- As a result of the lengthy ramp-up time for this program, TALF has been extended through March 31, 2010, for existing CMBS and through June 30, 2010, for newly issued CMBS.

Public-Private Investment Program (PPIP)

- PPIP was initially proposed to remove up to $1 trillion of legacy loans and securities from banks' balance sheets but has been scaled back to roughly $40 billion in legacy securities only. The Treasury cited improving financial markets as the reason for the change.
- The Treasury recently released its list of prequalified fund managers to participate in PPIP. Each fund manager is required to raise $500 million in private capital. The government has committed $30 billion to PPIP, which will be used to match private equity capital raised and to provide financing.

© 2009 Marcus & Millichap

Commercial Real Estate Market Conditions: Pages 6-7

- Commercial real estate sales volume during the first half of 2009 was down 75 percent from the same period last year and was 90 percent below peak levels recorded in the first half of 2007. The drastic reduction reflects a buyer/seller price expectations gap, as well as the tightening availability of financing. Buyer interest has been rising as more properties become available at realistic prices.
- Beyond hampering sales velocity, tight credit markets add another layer of complexity and challenge to commercial property owners, who have an estimated $550 billion of commercial mortgage debt slated to mature in the next two years. In many cases, lenders are focusing on minimizing further losses by modifying loan terms.

Emerging Opportunities in Commercial Real Estate: Pages 8-9

- As sellers become increasingly motivated due to maturing debt or general capital needs, a wide array of commercial properties will likely hit the market. To prepare for this opportunity, investors are defining strategies today to ensure they can move quickly when attractive assets become available. Pricing differentiation will persist, driven by property quality and location.
- In recent months, more buyers have re-engaged their pursuit of opportunities, and more owners have begun to accept market realities when pricing their properties. With ample capital waiting on the sidelines for the right time and/or opportunity to arise, the transaction market would likely be posting improvement already if financing was more readily available.
- Investors waiting to redeploy capital into commercial real estate until economic growth resumes or a central clearinghouse for distressed properties is established, similar to the Resolution Trust Corporation (RTC) in the early 1990s, run the risk of missing solid acquisition opportunities.
- The complexity of financial sector challenges has prompted an unprecedented amount of government stimulus and intervention, all of which require time to trickle through the system. Once credit markets are restored and economic growth resumes, investors will face significantly more competition from other prospective buyers when desirable acquisition opportunities arise.

Long-Term Outlook for Commercial Real Estate: Page 10

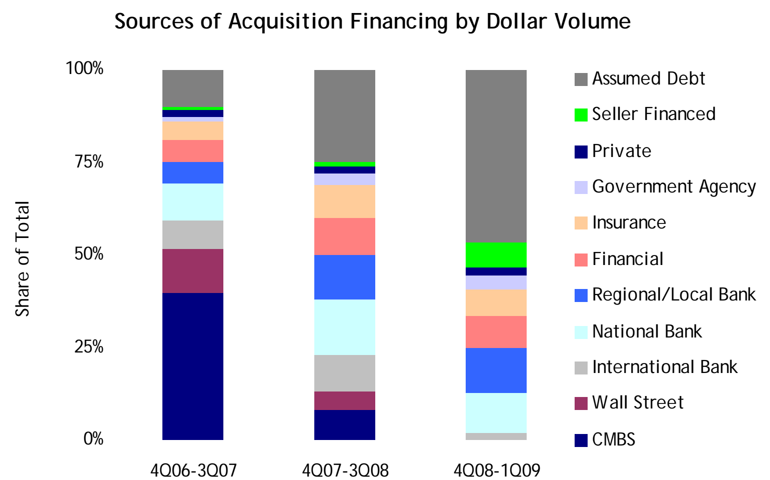
- Aside from retail, there was minimal overbuilding in recent years, and construction starts will remain limited through at least 2010. As a result, commercial property owners should have an opportunity to lease existing vacant space ahead of the next construction cycle.
- Payrolls were relatively lean heading into the downturn, and employers will need to rehire workers when a recovery takes shape. Consequently, the commercial real estate market could experience a relatively swift recovery compared to previous downturns.
- Demographic shifts and solid population growth in the coming years are expected to lend support to commercial real estate fundamentals. In addition to bolstering apartment demand, the growing population will require more services, reinforcing demand for other types of commercial space.

© 2009 Marcus & Millichap

Government Programs to Restart Commercial Real Estate Credit Flows Beginning to Show Promise

The potential for significant commercial real estate-related losses tied to maturing mortgage debt has emerged as a considerable risk due to constrained credit markets. As a result, government initiatives to improve commercial real estate credit, particularly the commercial mortgage-backed securities (CMBS) market, have been established. At its peak in 2007, CMBS accounted for nearly 40 percent of the increase in new commercial and multi-family mortgage debt outstanding nationwide. In mid-2008, CMBS issuance came to a standstill, and the void in the marketplace has clearly taken a toll on the commercial real estate sector.

The securitization of commercial mortgage debt should spread the risk associated with a pool of loans to many investors globally. Furthermore, because the debt is sold, lenders are able to replenish capital, thereby enabling new loan originations. During the liquidity boom, issuers of mortgage-backed securities (MBS) passed all risk to investors, so underwriting standards of the underlying loans were not closely monitored. When it became evident that the ratings agencies missed the mark in assessing the risks associated with some CMBS, demand for the product fell sharply. The escalation of the recession into a global financial crisis eliminated any hope for a quick turnaround of the securitized debt market. Over the next year, modifications to the securitization model will be necessary in order to restore investor confidence in CMBS. It is possible that changes will be mandated as part of the new administration's proposed regulatory reform.



Sources: Marcus & Millichap Research Services, Mortgage Bankers Association

Modifications to the securitization model are likely to include requirements for originators to maintain some level of economic interest in CMBS. This, in turn, should encourage lenders to uphold responsible underwriting standards. Freddie Mac recently drew upon this new model for its first offering of K Certificates in June. The $1 billion securitization of multi-family debt marked the first CMBS to clear the pipeline in a year. Unlike traditional CMBS, however, Freddie Mac is guaranteeing the senior bond classes. Based on the program's initial success, Freddie Mac could move forward with another securitization later this year.

Over the remainder of 2009, government programs should be instrumental in stimulating demand for traditional existing and newly issued, highly rated CMBS. This should, in effect, mark the starting point for clearing lenders' balance sheets and eventually lead to increased lending capacity for new commercial mortgage loans.

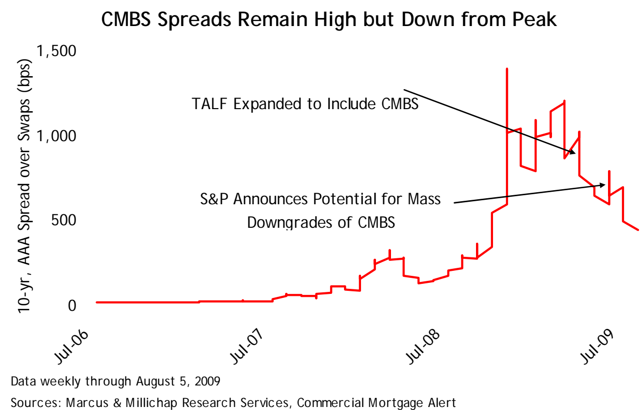
© 2009 Marcus & Millichap

Marcus & Millichap
RESEARCH SERVICES
THE OUTLOOK

Implementation of Government Programs Proves Complex

Government programs to jumpstart commercial mortgage lending have been modified in recent months, both in terms of size and scope, but they continue to move forward and appear on track to be operational by this fall.

Term Asset-Backed Securities Loan Facility (TALF). TALF was originally established to provide financing for the purchase of newly issued, consumer-related, asset-backed securities such as credit card debt and auto loans. In May, the government expanded TALF to include highly rated new and legacy CMBS in an attempt to help clear up lenders' balance sheets and increase new commercial mortgage originations. At the announcement of TALF's expansion to include CMBS, spreads narrowed dramatically. After peaking at more than 1,200 basis points over swaps in the first quarter of 2009, spreads on AAA-rated CMBS declined to approximately 600 basis points by late May. Spreads ticked up in the weeks that followed, after Standard & Poor's (S&P) announced that changes to its risk-assessment methodology could result in mass downgrades of once highly rated CMBS. More recently, S&P reversed its position and restated the ratings on some of the loan pools. Spreads for AAA-rated CMBS have since declined to 450 basis points over swaps, the lowest point since October of last year. Such fluctuations are indicative of the complexity and uncertainty still impacting the pending solutions for restarting the CMBS market.



Data weekly through August 5, 2009
Sources: Marcus & Millichap Research Services, Commercial Mortgage Alert

- Multiple deals adhering to TALF's strict guidelines are under way. In order to qualify for TALF, CMBS must have the highest credit rating available from at least two approved ratings agencies. Furthermore, the mortgage pools must consist solely of fixed-rate loans underwritten on current NOIs and valuations; construction loans are not eligible. Major lower-leverage owners such as REITs stand to benefit directly from the program. While developers and smaller private investors are unlikely to reap direct rewards from TALF, they should ultimately benefit from greater availability of debt capital as the credit markets begin to function normally.

- One of the first TALF offerings of newly issued CMBS could involve Developers Diversified Realty (DDR), a retail REIT. DDR is expected to borrow a combined $600 million against two pools of assets in its portfolio. The properties in these pools should qualify, because they are considered relatively low-risk, even in light of the current economic situation, since they offer stable cash flows and are occupied mostly by discount retailers. Furthermore, many of the properties in these pools are reported to be unencumbered at present, and the resulting loan-to-value ratio will be around 40 percent. Vornado Realty Trust is also reported to be assembling a TALF-eligible CMBS deal to raise between $550 million and $600 million for the REIT.

- The legacy CMBS component of the TALF program received requests for $670 million in loans at its first subscription date in July. After reviewing the requests, the Fed approved all but one of the 36 bonds submitted as collateral for TALF loans.

© 2009 Marcus & Millichap

Of the many government programs, TALF appears to hold the most promise for freeing up capital for commercial real estate lending in the near term. Since it can take a few months to organize a TALF-eligible CMBS deal, the program is off to a slow start, but the wheels are now in motion, and a growing number of large property owners and lenders will take advantage of the program by year end. While TALF was set to expire at the close of 2009, the program was recently extended to March 31, 2010, for existing CMBS and June 30, 2010, for newly issued CMBS.

Public-Private Investment Program (PPIP). Proposed government-private partnerships aimed at moving toxic assets off of banks' balance sheets were initially well-received and promising, but implementation has proven difficult. To start, banks have raised large amounts of equity capital without having to sell assets at deep discounts, reducing their motivation to participate in the program. Furthermore, some potential participants are reluctant to partner with the government, wary of possible restrictions that could be imposed at a later date.

As of the end of July, PPIP was moving forward but at a scaled-down level. PPIP had targeted the removal of up to $1 trillion of legacy loans and securities from banks' balance sheets; however, as financial markets improved, the government reduced its target for the first round to $40 billion in legacy securities only. The impacts of a scaled-back PPIP on commercial real estate investors are mixed. While it may take more time for banks to clear their balance sheets of toxic mortgage-related securities, their lack of enthusiasm for the program signals that mortgage term extensions and workouts are likely to continue as a major focus, especially for higher-quality assets.

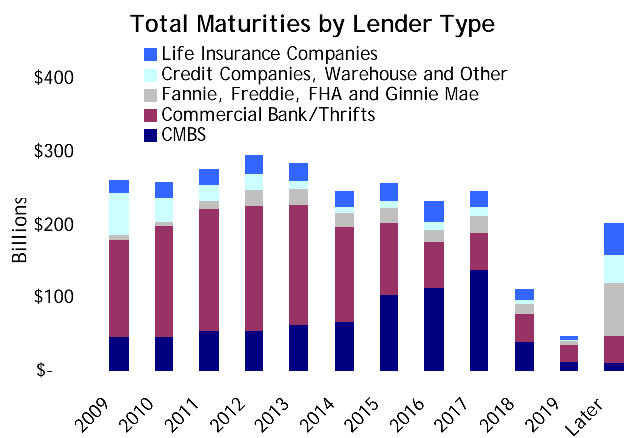
- **Legacy Securities Program.** As part of the PPIP, the Legacy Securities Program allows prequalified fund managers to receive an equity contribution and favorable financing from the government to purchase legacy securities. These securities include existing CMBS that were highly rated at the time of issuance. If successful, the program could provide an important price discovery tool, one of the first steps in restarting credit markets and freeing up capital for new lending.
  - In early July, the Treasury formally announced its list of nine prequalified fund managers to participate in the first round of the Legacy Securities PPIP. Fund managers have 12 weeks to raise at least $500 million each in private capital, in addition to investing a minimum of $20 million of their firm's capital into the Public-Private Investment Fund (PPIF).
  - The government committed $30 billion to the program to match equity capital raised from private sources and to provide up to 100 percent financing of the total equity in the PPIF. The first round of the PPIP holds the potential to remove up to $40 billion of legacy securities from banks' balance sheets.
- **Legacy Loan Program.** In conjunction with the PPIP, the Legacy Loan Program was intended to help banks move whole loans off of their balance sheets. In June, the FDIC postponed a pilot sale by open banks through its Legacy Loan Program, citing banks' ability to raise capital successfully without moving these assets off of their balance sheets. At the same time, however, the FDIC announced plans to test a similar funding mechanism to sell receivership assets of failed institutions this summer. While the platform may draw from the model utilized by the Resolution Trust Corp. (RTC) in the early 1990s, the list of failed banks consists of mostly smaller institutions; therefore, the quantity, size and quality of assets offered by the FDIC in the foreseeable future will likely pale in comparison to the RTC days.

© 2009 Marcus & Millichap

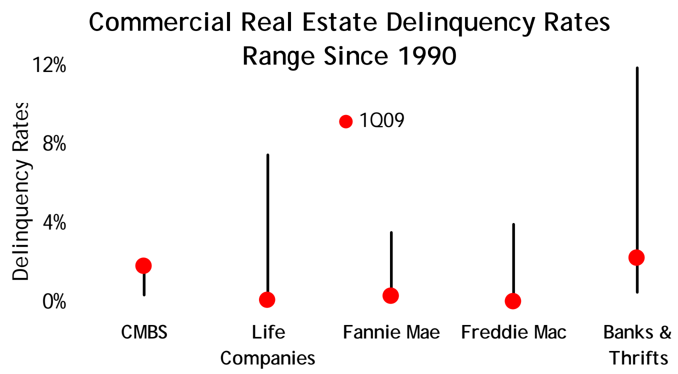
Tight Financing Climate, Weakening Fundamentals Remain Key Challenges to Commercial Real Estate Market; Economic Bottoming a Positive Sign

Wave of Maturing Commercial Mortgage Debt Approaching. The tight financing climate is not only hindering acquisitions but adding another layer of complexity and challenge for commercial property owners with maturing debt. In the next two years, an estimated $550 billion of commercial mortgage debt is scheduled to mature. A significant share of this debt is unlikely to qualify for refinancing without equity contributions by the owner. Issues could become more severe as debt originated from 2005 to 2007 matures, since loan-to-values (LTVs) during this period were at historically high levels, and many loans were underwritten based on overly optimistic occupancy and rent growth assumptions. The impact on the market is likely to be substantially minimized by lenders' focus on workouts and modifying loan terms, at least in the short term.

Delinquency Rates Rising. During the first quarter of 2009, CMBS delinquency reached 1.85 percent, up from less than 0.5 percent early last year and the highest level on record. The delinquency rate for loans issued by banks and thrifts jumped to 2.28 percent in the first quarter, a 90 basis point rise from six months earlier and on par with the rates reported in the mid-1990s. Commercial mortgage delinquencies among life insurance companies Fannie Mae and Freddie Mac also have increased in recent quarters but remain low at less than 0.35 percent, as these lenders maintained conservative underwriting standards throughout the most recent real estate boom.



Sources: Marcus & Millichap Research Services, Foresight Analytics



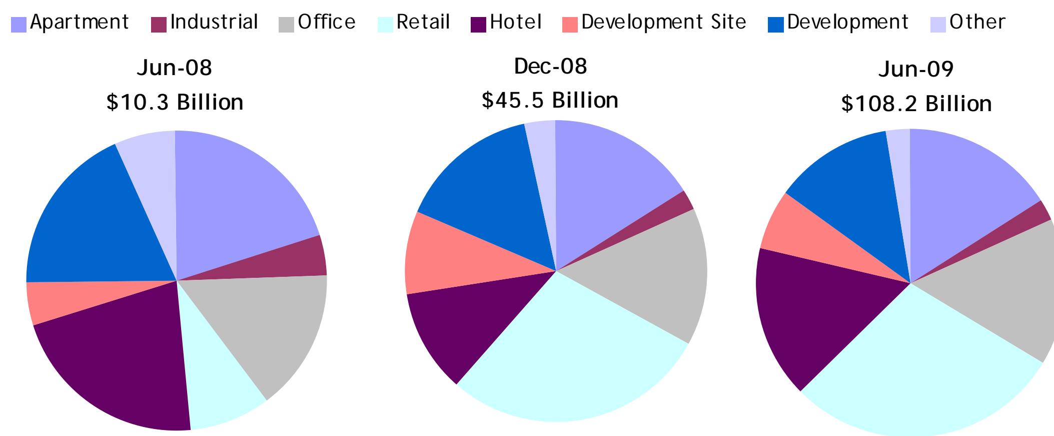
Freddie Mac- 60+ days from 1990-2Q08, 90+ days from 2Q08-1Q09
Prior to 1996 commercial bank and thrift figures are for commercial banks only, including construction and land development
Sources: Marcus & Millichap Research Services, Wachovia, LLC and Intex Solutions, Inc., ACLI, Fannie Mae, Freddie Mac, OFHEO and FDIC

Portfolio Lenders More Amenable to Commercial Mortgage Modifications. Many portfolio lenders are actively working with borrowers to modify loan terms and avoid foreclosures. The situation is more difficult for owners with CMBS loans, as multiple parties hold an interest in the mortgage. Delinquent CMBS loans also are transferred to special servicers that have strict limitations related to property foreclosures and distressed sales, further delaying a large inventory of discount sales coming to market.

© 2009 Marcus & Millichap

Distress Spreading. Since the start of 2008, the volume of distressed commercial real estate has swelled to an estimated $115 billion. Distress was initially concentrated among failed development and condo conversion deals, but the office sector took the lead in the fall of 2008 as the financial crisis intensified. The composition of distressed properties has since shifted again, with retail properties now accounting for the greatest share, or 30 percent of the total, up from less than 10 percent one year ago. Of the core commercial real estate sectors, retail recorded the most significant speculative construction in recent years as developers chased, and even built ahead of, rooftops into far-reaching suburbs. The reversal of housing-related fortunes and shrinking stock portfolios have contributed to the loss of $13 trillion from the overall net worth of U.S. households since mid-2007, resulting in a drastic pullback in consumer spending and a growing propensity to conserve cash.

Cumulative Distress by Property Type



Sources: Marcus & Millichap Research Services, Real Capital Analytics

Commercial Lending at Bottom? Commercial mortgage originations continued to decline during the first half of 2009, reflecting further reductions in loan demand and broad-based constraints on debt capital. In the first quarter alone, originations were down 26 percent from the fourth quarter of 2008 and were nearly 90 percent below levels reported prior to the onset of the credit crunch two years ago. Fannie Mae and Freddie Mac have recorded the lightest decrease in originations over the past year, as their multi-family loan portfolios continue to perform well.

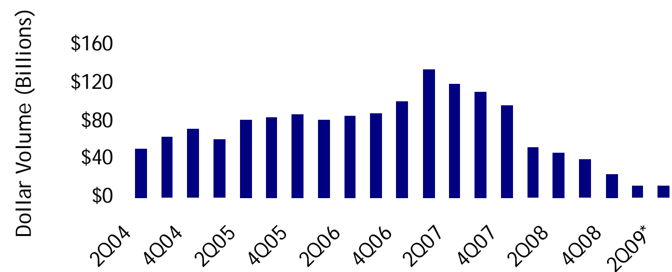
With the exception of Freddie Mac's recent securitization, CMBS issuance has been at a complete standstill since last June, while life insurance companies generally remain on the sidelines. Over the past several quarters, real estate investors have relied largely on commercial banks for new loans, which have become wary of originating large loans and increasing their risk exposure to individual assets. The limited amount of debt available from traditional lenders has resulted in a drastic increase in assumed or seller-backed financing in transactions, which now accounts for more than half of the marketplace, compared with only 11 percent a few years ago.

© 2009 Marcus & Millichap

Investment Activity Remains in Lull; Price Differentiation Based on Quality, Location

Tight Credit Hampering Commercial Real Estate Sales. The escalation of the credit crunch to a full-blown financial crisis in the fall of 2008 led to additional constraints on tight commercial real estate financing, reducing sales activity further through the first part of 2009. Prior to the near shutdown of credit markets last fall, commercial real estate sales volume was already down 70 percent from peak levels. The trend gained momentum through the end of 2008 and first half of 2009, with sales volume 90 percent below its peak as of the second quarter.

Commercial Real Estate Investment Dollar Volume



Estimate (includes apartment, office, retail and industrial sales)
Sources: Marcus & Millichap Research Services, CoStar Group, Inc., RCA

Buyer/Seller Disconnect Easing. In addition to the tighter financing climate, the wide gap between buyers' and sellers' price expectations is a major contributor to the drop-off in property sales. The disconnect became more severe in recent quarters, as buyers anticipated far deeper discounts due to rising distress and weaker fundamentals. There is some evidence emerging that sellers are becoming more accepting of current market sentiment, with cap rates on newly offered properties up approximately 50 basis points to 100 basis points from last year. At the same time, buyers are recognizing the difference in pricing based on market and property quality. Many investors remain on the sidelines, but interest in commercial real estate has increased, as have available inventory and offer activity.

Commercial Real Estate Investors Re-Evaluate Strategies as Downturn Continues. Until earlier this year, many owners were operating under the assumption that they were well-positioned to ride out the downturn. The deepening of the financial crisis last fall, however, led to severe job cuts across industries, as many companies were unable to secure short-term financing to fund basic operations. As a result, space demand deteriorated rapidly, cutting into NOIs and property valuations. With forecasts calling for continued economic weakness in the near term and rising distress in the commercial real estate sector, more property owners will opt to adjust prices rather than risk further equity erosion or a foreclosure.

Negative Investor Psychology vs. Long-Term Opportunity. Government programs to jumpstart the credit markets are promising, but they are only the first step in reversing the negative feedback loop currently in play throughout the commercial real estate segment. One of the most challenging issues to overcome for the investment market will be the negative psychology that has permeated the commercial property sector. Many investors are awaiting the return of economic growth to redeploy capital into commercial real estate. These investors run the risk of missing acquisition opportunities, particularly for properties that rarely change hands, as more of these assets are now available at reasonable prices.

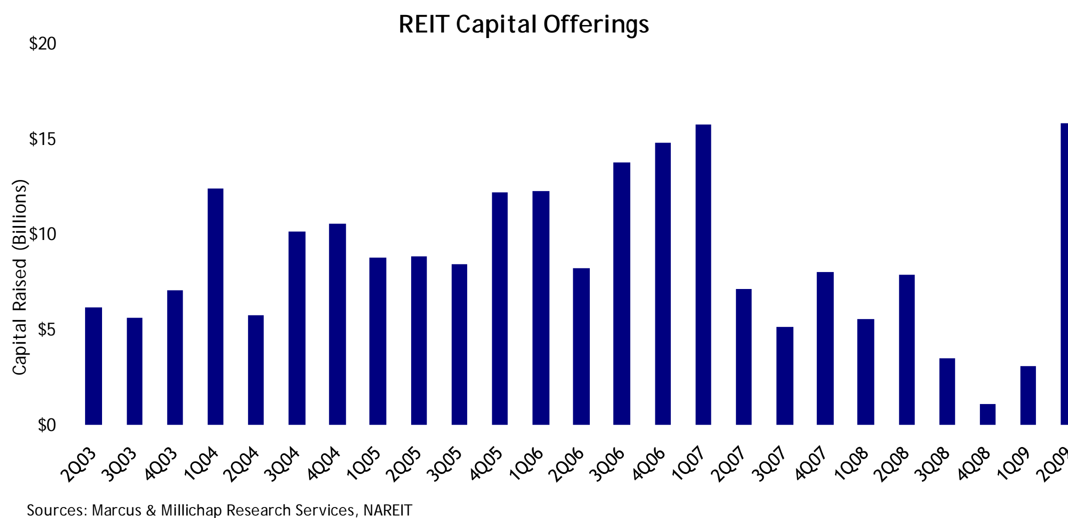
Central Clearinghouse for Troubled Commercial Properties Unlikely. While the FDIC will begin to accept bids on failed bank assets this summer, offerings are unlikely to include a significant number of individual commercial properties. In the early 1990s, the RTC helped to liquidate real estate- and

© 2009 Marcus & Millichap

mortgage-related assets of failed Savings and Loan Associations (S&Ls). At that time, it was typical for institutions to hold whole loans on their balance sheets. The situation today is far more complex due to the securitization of mortgage debt, which grew out of the S&L crisis. Furthermore, compared to the S&L crisis, the number of bank failures during the current downturn has been relatively low. Even if a central clearinghouse was established to liquidate bank assets, it would likely be on a much smaller scale than the RTC. Disposition of troubled loans has largely been left up to individual institutions and government agencies.

Opportunities Emerging. Unlike stocks and bonds, real estate investors must wait for properties to be offered for sale, and some assets rarely trade. As sellers become increasingly motivated due to maturing debt or capital needs for other assets in their portfolios, a wide array of commercial properties should emerge. This will mark a unique window to acquire assets that fit long-term strategies at attractive returns, including core, stable properties in solid locations. Investors with expectations of unrealistic discounts relative to quality will find it difficult to participate.

Plenty of Capital Parked on Sidelines. There is already a significant amount of private and REIT capital available for well-priced, quality assets to be offered for sale. During the first six months of this year, REITs raised approximately $19 billion, some of which will be used to pay down existing debt, but it is likely a portion has been set aside for acquisitions. As lower-leverage investors, REITs may face limited competition for large assets, since obtaining financing for properties priced at more than $15 million has become particularly challenging.



© 2009 Marcus & Millichap

Cause for Cautious Optimism. Despite the recent drop-off in commercial real estate investment and expectations for further softening in vacancy this year, several variables continue to support a positive long-term outlook for the sector.

- Government stimulus and credit facilities need more time to trickle through the system. The complexity of financial sector challenges has hampered the progress of programs such as PPIP and the CMBS component of TALF, which are only now beginning to gain momentum. Programs designed to encourage auto sales and first-time home buying also are under way, and only a small share of the funding made available through the $787 billion American Recovery and Reinvestment Act has been spent to date.
- Payrolls were relatively lean heading into the current downturn. With approximately 6.7 million jobs lost since the recession began, many businesses will need to rehire workers somewhat quickly when an economic recovery gains traction. As a result, the commercial real estate market could experience a relatively swift increase in space demand when compared to other recoveries.
- Productivity rates are rising, and companies have been able to reduce expenses significantly in recent quarters. Consequently, companies are well-positioned to record strong profit growth when the economy rebounds. Furthermore, with the unemployment rate at 9.4 percent and likely to reach 10 percent by year end, there will be plenty of slack in the economy. This will limit wage and pricing pressures as a recovery takes shape, reducing inflation concerns in the near term. Overall, businesses should be able to expand somewhat rapidly when demand for goods and services accelerates.
- During the most recent period of economic expansion, there was minimal overbuilding in the commercial real estate sector, outside of retail. Through at least 2010, weakened commercial real estate fundamentals and tight credit markets will lead to the deferral or abandonment of many projects in the pipeline and hamper the pace of new projects entering the planning phases. As a result, owners will have an opportunity to lease existing vacant space ahead of the next construction cycle.
- The nation's savings rate has skyrocketed in recent quarters, as consumers remain cautious. Once economic uncertainty begins to ease and signs of growth re-emerge, consumers will likely increase spending, albeit not to the degree recorded in the years of easy lending and double-digit home price appreciation. Since consumer expenditures account for roughly 70 percent of U.S. GDP, even moderate retail sales growth of 3 percent to 5 percent would support overall economic expansion.
- Demographic shifts such as the aging of baby boomers and the passage of echo boomers into their prime renting years, along with solid population gains due to natural growth and immigration, will support a positive outlook for apartment and commercial space demand well into the future.

Written by:

Erica Linn
Senior Analyst
elinn@marcusmillichap.com
(602) 687-6700

Edited by:

Hessam Nadji
Managing Director
hnadji@marcusmillichap.com
(925) 953-1700

For more information, contact: John Chang, National Research Manager, at jchang@marcusmillichap.com or (602) 687-6700.

© 2009 Marcus & Millichap

The information in this report is deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, expressed or implied, may be made as to the accuracy or reliability of the information contained herein. Sources: Marcus & Millichap Research Services, Commercial Mortgage Alert, Deutsche Bank, Economy.com, FDIC, Federal Reserve, Mortgage Bankers Association, National Association of Real Estate Investment Trusts (NAREIT), Real Capital Analytics (RCA), Standard & Poor's, U.S. Treasury Department