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The state of the commercial real estate mortgage market: 2009-2010 will be a difficult year

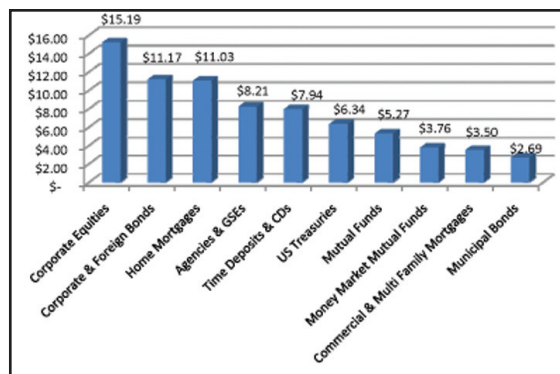
mk Michael Kondracki



Wawona
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The U.S. is a \$15 trillion economy as measured by GDP. Our biggest banks have trillions of assets under management and the U.S. stock market, as measured by corporate equities, hovered just above \$15 trillion at the end of 2008.

According to the latest data from the Federal Reserve's Flow of Funds released last Thursday, there are some \$3.5 trillion of commercial and multifamily mortgage loans on the balance sheets of financial institutions and in CMBS markets. This compares with \$11.03 trillion of



Source: Federal Reserve Flow of Funds Accounts of the U.S. Report 12/31/08

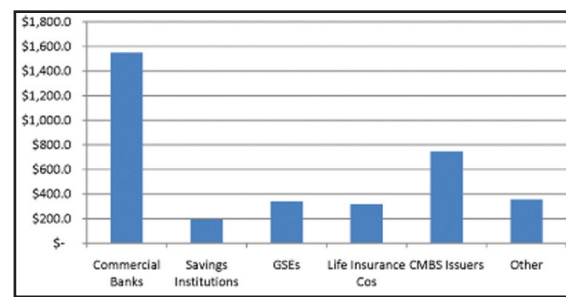
residential mortgages outstanding.

Approximately 25% of commercial real estate debt is securitized. However, the CMBS market has been closed since last year; Issuance stalled at 12.1 billion in 2008, down more than 90% from the \$230 billion that the sector issued in 2007.

And experts predict that only about \$11B of CMBS will be is-

sued this year. This would be the lowest level of issuance since 1991. Importantly CMBS lenders had accounted for about third of all new commercial mortgage activity so the closed market is causing a severe undersupply of credit.

Meanwhile, pension funds, banks and insurance companies are increasingly focusing on maturing loans with their existing customers,



Source: Federal Reserve Flow of Funds Accounts of the U.S. Report 03/12/09

and are loathe to take on new clients, further tightening the commercial mortgage credit spicket.

The situation is further exacerbated by two phenomena: A) AAA CMBS 10-year credit spreads are at all time highs; and, B) Delinquencies keep shooting up. With respect to spreads, CMBS spreads virtually preclude the creation of new loans because lenders would have to charge rates in the teens to support current bond yield requirements. Such pricing does not leave enough loan proceeds for most borrowers to pay off their maturing loans. Hence, the pricing and valuation issues that the CMBS market is having are resulting in marked illiquidity.

With respect to delinquency, a delinquent loan is one that is at least 30 days past due and still accruing interest. Delinquencies among rated CMBS ended the year at 1.17%. The dollar amount delinquent was \$6.86 billion which was much more than the \$3.98 billion that was reported delinquent in 2003. Rating agencies like Fitch see CMBS delinquency rates climbing to 2% for 2009. S&P sees delinquency rates climbing to 3% in 2009. Moody's has been even more conservative. It has downgraded over \$60 billion of CMBS recently and is applying new assumptions about falling property cash flows and stressed capital rates when considering the rating of CMBS bonds.

Moody's believes that cumulative losses on CMBS issued between 2006 and 2008 will be around 5% because it expects a significant decline in future property cash flows on higher tenant defaults, bankruptcies and sharp declines in lease-renewal rates.

Part of the spike in delinquencies in the fourth quarter of 2008 was due to the failure of a \$104 million note backed by a portfolio of two hotel properties in Tucson, Az. and Hilton Head, S.C. as well as the default on a \$125.2 million loan secured by a shopping center in Corona, Calif.

In this regard, retail and hotel properties as well as office buildings are struggling amid the credit crunch and global recession:

- Hotels: \$874 million in loans were reported delinquent in the 4th Qtr, a 375% year-on-year increase.
- Retail: \$1.9 billion in loans were

reported delinquent in the 4th Qtr, representing an annual increase of 318%.

- Office: saw \$1.10 billion in loans reported as delinquent in the 4th quarter, with national office vacancies increasing to 14.5% in the same quarter.

According to Foresight Analytics, some \$160 billion-\$400 billion of commercial mortgages is set to mature this year. Loans maturing face a CMBS market that has been shut down since the latter part of 2008 and a banking industry that is already saddled with bad assets from the residential sector.

Based on the unpaid principal balance of loans (UPB), delinquency rates for each group at the end of the fourth quarter were as follows:

- CMBS: 1.17% (30+ days delinquent or in REO);
- Life company portfolios: 0.07% (60+days delinquent);
- Fannie Mae: 0.30% (60 or more days delinquent)
- Freddie Mac: 0.01% (90 or more days delinquent);
- Banks and thrifts: 1.62% (90 or more days delinquent or in non-accrual).

While a 3% commercial delinquency rate would be the highest since 1996, it would remain far lower than the 7.5% registered at year-end 1991.

There is also another ominous trend. Commercial banks are carrying more and more CMBS on their books. At year end 2008 commercial banks held over \$1.5 trillion of CMBS on their balance sheets, or 44% of the current total CMBS outstanding.

While much has been made of this exposure, the Mortgage Bankers Association reported last week that delinquency rates must be put in context. Of the 35,069 commercial/multifamily loans in life company portfolios, with a total unpaid principal balance of \$253 billion, only 33 loans with an aggregate unpaid principal balance of less than \$168 million were 60+ days delinquent at the end of the quarter. Similarly at FDIC-insured banks and thrifts, of \$1.3 trillion of commercial/multifamily mortgages outstanding, only \$21 billion was 90+ days delinquent.

In short, 2009-2010 will be very difficult years for the CMBS market and for potential issuers to borrow and refinance. However, we at Wawona Worldwide Capital stand ready to assist our customers during these volatile times.

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Use a §1031 exchange to postpone paying gains tax

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When you, the taxpayer, (whether as an individual or as an entity) own property held for investment or for business use, sell it at a gain, you incur a gains tax at the time of the sale. Internal Revenue Code's section 1031 allows you to postpone the payment of such tax if the proceeds are utilized towards the purchase of a replacement property in a qualifying like-kind exchange. When you defer the tax, it frees up your money to make it available to invest in other projects. Despite its tax savings benefits though, the exchange process can create issues for commercial real estate investors and you ought to be savvy about the definitions of like-kind, timelines, IRS regulations, possible interference with your business models and the complexity of related party issues.

Owners of investment and business property including individuals, C Corporations, S Corporations, partnerships (general or limited), limited liability companies, trusts and other taxpaying entities may engage in a 1031 like-kind exchange. A like-kind property is property of the same nature, character or class.

Quality or grade are not of relevance. The relinquished property and the replacement property must be held for use in a trade or business or for investment and be similar enough to qualify as "like-kind." A residential rental house is like-kind to vacant land, but improvements that are conveyed without land are not of like-kind to land. Real property and personal property can both qualify as exchange properties, but real property is not like-kind to personal property. Real property within U.S. is not like-kind to property located outside the U.S.

You have 45 days from the date that the relinquished property is transferred to identify replacement properties. The exchange must be completed within 180 days after the transfer of the relinquished property or by the due date of the taxpayer's federal tax return for the year in which the relinquished property was transferred, whichever is earlier. The replacement property, if disposed of immediately after the exchange, would not be viewed as being "held" for a qualified purpose (investment) under the Internal Revenue Code's section 1031 and may trigger the entire exchange to be treated as a taxable event.

Last but not the least, your business model may dictate that the replacement property be transferred immediately to a corporation, partnership or an LLC, but tread that path with caution, as it may require you to prove your intent to hold the property for investment and IRS

may determine that on a case by case basis.

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By Maginelli and Goulet of KeyBank R.E. Capital

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take as little as two months from start to finish: two weeks from loan application to rate lock, another four to five weeks for a firm commitment and one to two weeks from commitment to closing.

A Bright Spot for Borrowers

Capital, the increasingly elusive commodity, is needed more than ever and is sought by lenders and borrowers alike. There is a surprisingly simple solution for New York multifamily owners: Agency financing for borrowers who partner with the right bank. For first-time agency borrowers, the process may seem intimidating, but it is not as complicated as it sounds – and the cost of capital and turnaround time are attractive to all involved.

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