

## Market Shifts from Stress to Distress

What a year it has been! One year after the greatest financial calamity since the Great Depression, it is clear that, with the support of the Federal Reserve and federal government, the credit markets will survive (despite the ongoing debate about the demise of Lehman Brothers and the additional market uncertainty that resulted because of it).

But while the stress on the credit markets has been relieved somewhat, the distress in the commercial real estate market is intensifying. Due to the nature of the earning structure, transparency, and valuation of commercial real estate, commercial real estate pricing and activity generally lags the economic and financial activity by approximately 12 months. With unleveraged equity real estate having already been repriced downward by roughly 30 percent thus far, the fear is how much lower values and prices may go as the market works through this lag time. Investors who have over leveraged (by today's standards) are finding their capital structure in distress, or in many cases, that have no equity. As such, Real Estate Research Corp. is hearing from more and more market participants that they are considering defaulting on their loans and letting the properties go back to the lender. Even CalPERS recently gave up on a major office property in Portland, Ore., with a loan of \$70 million, when they pitched the key back to the lender. A new door and new chapter for this cycle has been opened.

Commercial real estate will face its greatest challenges since the 1990s over the coming year, as the process of repricing and an increasing number of distressed properties create more uncertainty for all investors. Evidence of this reality was the announcement that Sam Zell, the noted "grave dancer," is raising over \$600 million to buy distressed debt. The hope is that the rapid repricing that has already occurred in commercial real estate means that this process may also end more quickly than it has in previous recessions, and that prices do not decline much further.

As we look ahead to the next year, RERC anticipates:

- Cap rates will remain relatively stable for the near term, and while they may increase slightly, earnings will continue to be repriced significantly downward, leading to value and price declines;
- Values will continue to fall, with institutional properties repriced from peak to trough to a tune of 35 percent to 45 percent (unleveraged), and lower grade properties in many areas falling even more;
- Continued lack of liquidity in debt capital with a significant increase in the number of defaults;
- Banks and insurance companies will experience significant pressure from commercial real estate, which could reduce lenders' bargaining power in the workout and loan renewal process; and
- Opportunities emerge for investors to pick up some very solid commercial properties at distressed prices, and specifically from a debt perspective (i.e., buy the debt at a discount, with the expectation of taking over the equity).