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What to expect: Commercial real estate mortgage markets in 2009 to be a challenge

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With the United States economy in a recession for over a year now, we are undoubtedly feeling the impact of easy money from recent years. Consumer spending, a major driving force for the economy, has dropped dramatically in response to the ailing housing market and subsequently affected other market sectors. With the economy in such a precarious position, active borrowers and lenders should be looking forward to next year to prepare for what is to come. Below I've outlined my thoughts on current and future market conditions and described a few potential scenarios for lender-borrower relationships in 2009.

The commercial mortgage market was jolted over the past few weeks as AAA CMBS began trading at absolute yields in the 15% range. These securities are not being traded on fundamentals, but on fear. To put it in perspective, Fitch Ratings recently stress-tested $217 billion of CMBS issued in 2006-2007 under three different scenarios: mild, moderate and severe. Fitch concluded that under each of these scenarios, the AAA-rated classes suffered no losses. Under the severe scenario, losses only reached up to the single A+ class. However, with AAA classes trading at these levels, it makes it impossible for CMBS lenders to originate loans. Most CMBS lenders do not expect the market to return until 2010 at the earliest.

Based on current market conditions, I expect leverage to continue decreasing into 2009. Most lenders are beginning to employ higher cap rates, higher vacancy rates and lower rental rates as they underwrite properties, creating lower values and smaller cash flows. Even Freddie Mac and Fannie Mae are tightening their underwriting and increasing spreads in response to the capital markets. Borrowers with loans maturing in 2009 will most likely choose between providing out-of-pocket funds to pay off their maturing debt, trying to extend/modify their existing debt or even giving the property back to the lender. Lenders are anticipating the level of non-performing loans to increase on all asset types in 2009.

If a borrower expects to fall short on monthly debt service or experience a maturity default, he or she should be prepared to deal with the lender. The first thing the borrower should do is review all relevant loan documents to understand his or her rights versus the lender's rights and then begin mapping out a strategy. Secondly, the borrower should find out whether the loan is serviced by a third party (as most CMBS loans are) or if the loan is held by the original lender. Third party servicers are often limited in the measures they can take and they are required to consult the controlling party about potential actions against a borrower. In this case, the borrower will need to supply the lender with a comprehensive analysis of current and future cash flow, which shows a clear path to paying off the loan.

In some instances, the lender may be willing to take a discounted pay-off from the borrower to satisfy the loan. The motivation from the lender's point of view is to take what they can get now and avoid the long workout process or foreclosure on the property. Most lenders will take the path that provides the highest net present value, so the best solution often calls for the borrower and lender to agree on a discount.

While the cost of this capital is not cheap, it enables the borrower to pay-off existing debt and buys time for the property to stabilize. That way, the new lender can be paid off when the economy and the lending market begin to recover 12-18 months down the road.

2009 will be a challenging year for all participants in the commercial real estate market. As I have outlined above, it is crucial for borrowers to understand their rights as described by their loan document and stay abreast of current conditions in the commercial mortgage market.

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