# PCCP Market Commentary

## Stop Waiting for RTC 2.0

## Third Quarter 2012

*When is the great tidal wave of foreclosures going to occur so we can pick up assets at fire sale prices?*

CRE fundamentals continue to indicate a distressed market. CoStar has identified over 168,000 properties with a vacancy rate of 60% of more, compared to 80,000 in September 2009 (much closer to the bottom). There are twice as many 60% vacant buildings today as there were in late 2009. Real Capital Analytics reports that the overall level of distressed assets is down only 2% from 2010 to 2011 with over $57 billion of new troubled assets in 2011. The jobs picture continues to look weak with unemployment above 8% and another disappointing spring of job creation. The housing market is showing early signs of recovery, but housing is still a drag on the economy with prices down year over year on a national level. Today's distress is reminiscent of the early 1990's. And Europe is scaring everyone.

| Distressed Assets | | | |
|---|---|---|---|
| | Outstanding Distress | % Change vs. 2010 | Worked Out (%) |
| Office | $40,862 | 5% | 54% |
| Apartment | $34,926 | -12% | 54% |
| Retail | $28,680 | 6% | 55% |
| Industrial | $11,911 | 3% | 38% |
| Hotel | $22,133 | -18% | 57% |
| Land | $25,859 | 8% | 36% |
| Other | $4,738 | 19% | 38% |
| **All** | **$169,111** | **-2%** | **51%** |

*Source: Real Capital Analytics*

When the markets first plummeted in 2008, we all began to look for RTC 2.0. The overarching themes between the S&L Crisis and the Subprime Crisis are similar: drastic shifts in pricing, questionable regulatory environment, period of cheap lending, banks failing, government intervention, etc.:

| Similar Distress in Commercial Real Estate… | | |
|---|---|---|
| Category | 1990s | Today |
| **CRE Pricing Peak to Trough** | -27% | -49% |
| **CRE Peak to Trough Time** | 5 years | 3 ½ years |
| **Peak Bank CRE Delinquency** | 10% | 12% |
| **S&P 500 Peak to Trough** | -35% | -56% |
| **Failed Banks & Thrifts** | 747 | 433 |
| **…but Different Outcomes** | | |
| **10 Year Treasury Rate** | 7% | 2% |
| **Private Sector Response** | Buy from RTC | Extended and Pretend |
| **Government Response** | RTC- Liquidate Assets | TARP, TALF- Recap Banks |
| **Length of Recession** | 8 months | 18 months |
| **GDP Decline** | 5% | 3% |
| **Time to Clean Up** | 5 years | 8 years |

***Sources: Moody's CPPI Index, Federal Reserve, Google Finance, Ken Rogoff "This Time is Different"***

However, this time is different. The S&L Crisis was far more contained to the U.S., while the Subprime Crisis sent global financial markets into a tailspin. In the 1990's, domestic financial institutions folded, whereas this time around global financial powerhouses collapsed. During the 1990's real estate private equity was a nascent idea; today, $180 billion of dry powder is waiting in the wings. Banks in the 1990's were constrained by recourse lending; in recent years, non-recourse prevailed. When Continental Illinois failed in the 1980's, it had a $40 billion balance sheet. The Lehman Brothers bankruptcy involves over $600 billion!

Today, the U.S. CRE markets have evolved into a significant slice of the global financial markets. Resulting government intervention has taken a different form than it did during the S&L Crisis. Rather than taking on the underlying troubled assets and forcing a sale, during the Subprime Crisis the U.S. government injected liquidity to the financial system through TARP and TALF. Expansionary monetary policies including Quantitative Easing have allowed the Federal Reserve to maintain record-low interest rates. As a result, banks and lending institutions have been able to float troubled assets over an extended period of time rather than taking immediate losses. More astute/complex financial markets and a far more liquid CRE market have allowed the "recovery" to continue for over four years (so far)! We are still merely one-third of the way through the deleveraging and workouts required to rebalance the system. The fire sale associated with RTC 2.0 has not and will not occur (absent a spike in the cost of bank capital), but in our view, recapitalization opportunities will continue to come to the market regularly over the foreseeable future.

We do believe that in the near term, the pipeline of distressed deals will continue to be plentiful. While sales volume was up 57% in 2011 over 2010, and over $178 billion of troubled properties (51% of total) have been resolved,[1] bank loan portfolios decreased by *only* 5% in 2011.[2] The 1,000 largest banks still hold $63 billion of nonperforming assets.[3] The CMBS market struggles both to originate deals and to be repaid. Trepp reports that for the past year, only 44% of CMBS loans were paid off at maturity. This number excludes loans that were already delinquent at maturity which means only 44% of performing loans were refinanceable.[4] In reality, today's distress feels far worse and more long-term than the early 1990's. With $300 billion of loans maturing each year over the next five years, we anticipate seeing a constant flow of transactions coming to market, presenting plentiful opportunities for patient capital.

**CRE LOAN MATURITIES**

| | Banks | | CMBS | | | | |
|---|---|---|---|---|---|---|---|
| Maturity Year | Core CRE | Multi-Family | Conduit | Floater | Life Cos. | Other | Total |
| 2012 | $180.3 | $33.0 | $46.3 | $16.2 | $23.3 | $72.8 | **$372.0** |
| 2013 | 178.7 | 31.6 | 37.7 | 2.6 | 24.4 | 74.4 | **349.5** |
| 2014 | 154.9 | 27.9 | 50.1 | 0.3 | 23.5 | 72.5 | **329.2** |
| 2015 | 127.4 | 24.5 | 94.8 | 0.6 | 22.7 | 65.5 | **335.5** |
| 2016 | 98.0 | 19.1 | 130.7 | 0.8 | 23.3 | 58.9 | **330.9** |
| 2017 | 74.8 | 15.0 | 134.8 | 0.0 | 22.2 | 51.6 | **298.5** |
| 2018 | 59.2 | 11.9 | 6.6 | 0.1 | 19.5 | 43.8 | **141.1** |
| 2019 | 38.1 | 7.7 | 2.7 | 0.0 | 16.8 | 34.7 | **100.0** |
| 2020 | 28.1 | 5.9 | 2.2 | 1.1 | 14.8 | 25.1 | **77.2** |
| **Total** | **$939.5** | **$176.6** | **$505.9** | **$21.7** | **$190.5** | **$499.3** | **$2,333.9** |

*Source: Morgan Stanley Research, Foresight Analytics, Trepp, Intex*

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[1] *Real Capital Analytics*
[2] *Commercial Mortgage Alert*
[3] *Commercial Mortgage Alert*
[4] *TreppWire Daily CMBS Commentary and Market Observations Email*