

# FALCON

REAL ESTATE INVESTMENT COMPANY, LP



*Comprehensive Services for Investors in U.S. Real Estate*

FIRST QUARTER 2010, VOL. 19, NUMBER 1

## Why Are So Few Properties for Sale?

Ever since the financial markets of the world were overwhelmed by the credit crisis in late 2007, many analysts have speculated that a tremendous problem was about to develop in the US commercial real estate market. The general expectation has been that with the collapse of the commercial mortgage-backed securities (CMBS) market and with the reluctance of most banks to make new mortgage loans, there would be a flood of foreclosed and distressed real estate that would engulf the market. That this did not happen in 2008 or 2009 has surprised many observers. And it was not just that the number of transactions in the commercial market was at a record low level in 2009, it has been even more surprising that so few properties are being offered for sale.

Two questions arise from this situation: first, why have so few properties come to market following the collapse of the mortgage market, and second, is this situation likely to change in 2010? There have been many reasons both the banks and the special servicers for CMBS loans have been slow to foreclose on loans that are in default. And both groups have actually resorted to various strategies to keep from having to foreclose on such loans. In Falcon Real Estate's view, conditions may be changing in 2010 to bring more properties to the market, but this will be a gradual process, and we do not believe that the market is about to be overwhelmed by property offerings, as has so often been predicted.

### THE BANKS' SITUATION

With few exceptions, most banks in the United States, both large and small, were heavily invested in assets that depended, directly or indirectly, on the US residential real estate market. And most of those investments had been leveraged to extraordinary levels. As a result, when the residential market collapsed, the banks were faced with the huge problem of writing down all of these assets and attempting to restore their balance sheets. Given the magnitude of the problem in the residential market, the banks were not anxious to face up to the much less serious problems that have begun to arise in the commercial market. Therefore, the banks have had little or no motivation to foreclose on assets that will only add to the problems with their balance sheets.

As a result, the banks have in many cases been willing to grant short-term extensions of maturing loans. Some have labeled this policy "lend and pretend" since the extensions

are frequently being granted without recognizing the decline in value that has occurred and in the hope that the market will improve before the loan matures again. This enables the bank to avoid taking a write-down on its balance sheet. The expectation is that the economy will improve during the next two years and the mortgage market will revive so that the distressed borrower will be able to refinance and remove the problem loan from the bank's balance sheet. The banks have also been reluctant to foreclose since they have not wanted to assume management responsibility for a large number of properties. They generally do not have the asset management capabilities that would be necessary for them to do this.

The banks also face a problem with contentious borrowers. In many cases, borrowers are facing foreclosure since they are unable to refinance solely due to conditions in the mortgage market, even though the underlying property is fully leased and is performing exactly on budget. And

---

there is frequently equity remaining in the property even at current depressed prices. As a result, many borrowers are resorting to the courts seeking the protection of the bankruptcy laws. If nothing else, these tactics have succeeded in delaying those situations where the banks have attempted to foreclose.

## **THE CMBS SITUATION**

---

The situation with respect to CMBS mortgages is more complicated. The ownership of a given mortgage may be divided up in a number of different ways. When a pool of mortgages was sold, there would probably be a considerable number of investors from various parts of the world who would become owners of that pool and indirect owners of a given mortgage. In addition, a mortgage itself could have been divided up into various parts. During the peak of the CMBS market (2005-2007), subordination levels of CMBS pools were under 15% (that means that 85% of the pool was rated AAA and 15% of the pool was "subordinate" or rated below AAA). As a result, the special servicer who might handle such a defaulted mortgage has to deal with multiple, and possibly conflicting, ownership interests. In addition, since normal subordination levels had been in the 25% to 35% range, the likelihood of problems arising in the "lower risk" or AAA portion of the mortgage was significantly increased. Considering all of these factors, this is not a situation that would lead to quick or easy foreclosures.

It should also be noted that the special servicers do not have the same incentives as the bank. They do not have any balance sheets that the Federal Government is pushing them to clean up; their only interest is in maximizing value for the investors. If this means holding the property for a time after foreclosure, managing that property and even re-structuring it, the special servicers are perfectly willing to follow that course of action. And the special servicers are typically the owners of the B, or higher risk, pieces that are, in a great many cases, out of the money right now. They have limited incentive to take a property back since they would not only give up the special servicing fees, but they would also give up their hope to someday be in the money again.

## **THE LIQUIDITY FACTOR**

---

Another major factor that is keeping many properties from being offered for sale is the tremendous amount of liquidity in the global economy together with the resurgent stock market. With the US stock market up about 60% since its low early in the year, many REIT's have been able to sell stock to raise cash and have thereby avoided having to sell properties. Many properties that were being offered at depressed prices six to nine months ago have now been taken off the market by the REIT that owned

them since it has raised money in the stock market and has now become a potential purchaser, rather than a seller, of properties.

Another factor affecting the market is the large amount of overseas capital that is poised to come into the US real estate market today. The US market has a number of competitive advantages: the dollar has been weak relative to the euro and other major currencies; yields in the US market are generally higher than in the real estate markets of major alternative markets, particularly those of Europe; the US market has not suffered from the tremendous overbuilding that has occurred in other parts of the world; and the US real estate market is considered to be relatively secure – from both a legal and political viewpoint – as compared to the markets of many emerging countries.

## **2010**

---

We do not believe that the mortgage market itself will revive during the first half of 2010 and this will keep pressure on both borrowers and lenders for most of the year. As a result, we think that the number of properties coming to market in 2010 will increase. The banks have actually made great progress in restoring their balance sheets, as indicated by the fact that all of the major banks, except Citibank and Wells Fargo, have repaid the Federal Government's emergency TARP loans (and they are currently in negotiations to do so). As their balance sheets and profitability continue to improve, it can be expected that the banks will be less likely to extend maturing loans, either forcing the borrower to sell the property or causing the bank to foreclose. At the same time, the special servicers for CMBS loans will gradually foreclose and bring more properties to market. As a result, there should be some increase in the number of foreclosed properties coming to market from both of these sources.

But more and more, existing owners of real estate, who have been holding on to their properties in the hope that the market would improve, and who recognize that they cannot refinance their existing mortgages, will decide to sell. After a decline in value of at least 30%, it will take time for existing owners to adjust to the reality of the current market, but we believe that this will happen as the year progresses. Therefore, we would expect that properties being sold by distressed owners, rather than foreclosed properties, will be the most important factor in the market during the coming year.

*For further information, log on to [www.falconreal.com](http://www.falconreal.com)  
or contact **Falcon Real Estate:***

*570 Lexington Avenue, New York, New York 10022  
[www.falconreal.com](http://www.falconreal.com)*