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THE OUTLOOK

Malls, Offices May Slump Less Steeply Than Homes

By **PETER GRANT**
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(See *Corrections & Amplifications* item [below](#).)

Even optimistic commercial-property developers are stacking sandbags to hold back a financial deluge in the market for office towers, hotels, shopping malls and other commercial real estate.

The consolation is that it looks like commercial property in the U.S. faces a once-every-25-year flood, not the once-a-century inundation facing the nation's housing market.

In recent weeks, sales of commercial property have nearly hit a standstill. And the market value of such properties -- and the mortgages on them -- have declined as the spreading fallout from the crisis in risky, or subprime, mortgages has made credit practically evaporate.

Developers are putting the brakes on new projects, cutting deals with tenants to keep space occupied and, if possible, extending the terms of their existing debt when it comes due. Some owners, like New York's Harry Macklowe and **Centro Properties** of Australia, a big investor in U.S. shopping malls, are under siege by creditors, forcing them to put properties on the block.

On the bright side, however, the commercial-property downturn isn't expected to be nearly as steep as the current slump in the housing market, where recent data showed foreclosures rising to the highest level on record in the fourth quarter of 2007.


Losses by commercial-building owners, lenders and investors are likely to be tempered by the lack of overbuilding in recent years and the ability of most office buildings and other commercial ventures to keep current on their mortgages.

That's partly because commercial properties typically produce income. While millions of American homes are under water because their value has fallen below the amount owed on them, most commercial buildings are generating enough cash to pay off their loans.

"Fundamentally the markets are in pretty good shape," says James Duca, managing director of Moody's Investors Service.

So far, most of the pain from the downturn has been borne by banks and other institutions that hold debt or securities collateralized by commercial-real-estate loans. These loans have fallen in

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value as the market has struggled to reappraise their risks.

The outlook could worsen if the U.S. falls into a deep recession, driving rents down and vacancies up. But even without a deep dive, it isn't going to be pretty.

J.P. Morgan Securities, which says the economy has entered a recession, projected last week that commercial-property losses over the next five to eight years will be about \$120 billion, or roughly 4% of the sector's \$3.2 trillion in debt outstanding. But that's far short of the \$200 billion in losses that J.P. Morgan is projecting from the subprime debacle, a 15% loss rate.

Less Pain This Time

Even more reassuring for property owners, most analysts are predicting that the pain this time won't come close to the carnage of the early 1990s, when major developers like Donald Trump and Olympia & York suffered financial crises.

William Tanona, a Goldman Sachs Group analyst, expects **Bear Stearns Cos.**, **Citigroup Inc.**, **J.P. Morgan Chase & Co.**, **Lehman Brothers Holdings Inc.**, **Merrill Lynch & Co.** and **Morgan Stanley** to take combined commercial-property-related write-downs of \$7.2 billion in the first quarter, following \$1.8 billion of them in the fourth quarter.

But most of those write-downs are due to the falling market value of the commercial-mortgage-backed securities on the banks' books. Mortgage lenders, by contrast, are suffering losses largely because of defaults. Countrywide Financial Corp., the nation's largest home lender, which accounts for about a fifth of U.S. mortgage-loan volume, recorded \$2.29 billion of provisions for loan losses in 2007, up from \$233.8 million a year earlier.

In congressional testimony in October, Mark Zandi, chief economist of Moody's Economy.com, predicted about three million home-mortgage defaults in 2007 and 2008 and that two million of those homeowners would eventually lose their homes.

Falling Home Prices

During the current downturn, commercial real-estate values are likely to fall 20% from their recent peaks, according to J.P. Morgan Chase. By contrast, Credit Suisse projected late last month that home prices, which peaked in 2005 and have declined substantially since, will fall an additional 25% to 40% in some regions before hitting bottom. The average price of a house in the Miami area, which has already fallen around 6%, is expected to tumble an additional 40%, the report says.

Policy makers have become increasingly concerned about the stresses commercial property are putting on small and midsize banks. But many of their problem commercial-real-estate loans are actually housing-related: The banks typically classify construction loans made to condominium and single-family home builders as "commercial."

In the fourth quarter of 2007, 7.5% of the loans from federally insured banks and thrifts to builders of single-family homes were 30 days or more past due, up from 2.1% a year earlier, according to Foresight Analytics, a research company in Oakland, Calif.

For banks

Showing Discipline



lending to

condo developers, the pain was even worse. Delinquencies for condo-construction loans rose to 10.1% in the fourth quarter, up from 2.6% a year earlier. By comparison, delinquencies on nonresidential commercial mortgages, secured by properties like office buildings and shopping malls, were 1.6% in the same quarter, up slightly from 1.1% according to Foresight Analytics.

The delinquency rate on the \$840 billion of U.S. commercial mortgage-backed securities outstanding is less than 0.5%, near its historic low, according to Trepp LLC, which tracks the market. While the rate is rising, Moody's doesn't expect it to exceed its average of closer to 2% over the next 12 months. Compare that with the roughly 20% of commercial loans made by life-insurance companies in 1986 that defaulted in the subsequent 10 years.

Why is the current bad-loan rate so low? For most of this decade, developers have been showing unusual discipline in delivering new product, with the exception primarily of hotels. Office-property developers in the top 50 markets this year are expected to complete 53.9 million square feet of office space, according to Reis Inc., a real-estate data company. While that's close to double the 2004 pace, it is less than 40% of the average 144 million square feet that was delivered annually in the five years leading up to the collapse of commercial real-estate prices in the early 1990s.

Sam Chandan, Reis's chief economist, says that commercial developers haven't overbuilt due to high construction costs and because the commercial real-estate market didn't start recovering from the last recession until 2004. Usually it takes a few years after a recovery before developers start building speculative projects that have little or no pre-leasing. "We weren't far along enough in the cycle for the market to start chugging," he says. "And then demand began softening because of [the] residential" market.

Now that financing has dried up, new development has screeched to a halt. That's bad for employment and the nation's economic output, but it also means most existing properties will be protected from new competition.

Hard-Hit Markets

In 1986, Moody's gave the nation's office sector a score of 13 out of 100 on a scale it uses to project the sector's health, meaning supply far outweighed demand. (A score of above 50 means market conditions are improving for landlords. A reading below 50 means they are getting worse.) Today, there are hard-hit markets, like the Phoenix suburbs, where office buildings have a Moody's score of zero because of overbuilding. But the national average score for the office sector is 52.

While office landlords haven't dropped their asking rents, many have started offering more concessions like interior construction work and months of free rent so their so-called "effective" rents are lower. According to Reis, effective rents were flat or falling in 16 markets in the fourth quarter of 2007, compared with seven markets in the third quarter.

The problem is that while most properties' cash flows are holding up, their values are falling primarily because financing is so much more costly. That's particularly scary for owners (and their lenders) who borrowed aggressively during the easy-money years of 2005 to 2007 and need to refinance soon. Many won't be able to borrow nearly as much or get the same terms, putting them at risk of default.

Of the \$44 billion in commercial mortgage-backed securities that need to be refinanced this year, \$24 billion is in short-term debt securities issued between 2005 and 2007, according to Moody's. Many borrowers will be able to extend existing loans. But the high-profile travails of Mr. Macklowe have shown what can happen when short-term loans on highly leveraged property come due.

Still, most commercial-property owners aren't as highly dependent on short-term financing as Mr. Macklowe. And most of those who borrowed during the easy-money years have seven- to 10-year terms on their loans, presumably enough time for the capital markets to figure out how to price real-estate and other forms of debt.

--James R. Hagerty and Lingling Wei contributed to this article.

Write to Peter Grant at peter.grant@wsj.com¹

Corrections & Amplifications:

A previous version of this article incorrectly said that there was a collapse of commercial real-estate prices in the early 1999s. The collapse was in the early 1990s.

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(1) <mailto:peter.grant@wsj.com>

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