THE COMMERCIAL PROPERTY MARKETS OF THE WORLD:
<u>THE NEXT CRISIS, WAITING TO HAPPEN !</u>

More than $US9 trillion (about $HK70.20 trillion) have been invested in commercial real estate, internationally, according to the latest statistics, but many, if not most, of these properties are geared by more than 75 percent.

The use of the word, *'geared'*, in this case, means the proportion of capital, existing in the form of debt. This is, sometimes, referred to as **L**oan-**T**o-**V**alue Ratio, or the LTV Ratio.

Roughly, the US accounts for about $US4 trillion ($HK31.20 trillion) of the commercial real-estate loans, afforded to the legal owners of these properties, followed by Europe, with about $US3.30 trillion ($HK25.74 trillion).

It is known that US banks hold about half of all of the commercial real-estate loans in the country on their books.

That is about $US2 trillion (about $HK15.60 trillion).

To understand the importance of this figure of $US2 trillion, it is about 24 percent of all bank loans, outstanding today.

Also, investment in commercial real estate in both the US and the United Kingdom is equivalent to about 30 percent of the **G**ross **D**omestic **P**roduct (**GDP**) of both countries.

GDP is defined, generally, as being a country's income minus foreign investment: The total value of all goods and services, produced within a country in a year, minus net income from investments in other countries.

In Europe, banks in this part of the world hold commercial, real-estate loans, totalling not less than $US2.60 trillion (about $HK20.28 trillion) on their books.

The default rates of commercial, real-estate in the US are known to have risen, materially, since the beginning of 2007, according to the US Federal Reserve.

For the first time since the first quarter of 2007, the growth rate of defaults in respect of commercial, real-estate loans in the US has fallen to single digits, The Fed's statistics indicate.

What is very worrying to many economists about this situation is:

How can commercial real-estate loans be refinanced in view of the Loan-To-Value Ratios?

In many cases, the current market value of a great many highly geared commercial properties in both the US and Europe are below the level that makes refinancing them a viable commercial proposition for banks and/or finance houses.

Repossession may not be an option for many banks/finance houses because that would not ameliorate the situation, one iota.

In the US and Europe, there have been sharp corrections in the commercial, real-estate markets.

In London, England, office rents have dropped by more than 30 percent from their peak.

In Paris, France, office rents have dropped by about 15 percent from their peak.

In Barcelona, Spain, office rents have dropped by about 25 percent from their peak, and, in Dublin, Ireland, the falls are much greater, close to a drop of about 50 percent from their peak.

And, at this time, there is no light at the end of this tunnel, also, to be trite.

Since the first half of 2009, transactions in commercial, real estate have fallen in the US and Europe, putting more strain on purchase prices, resulting in the knock-on effect, being to lower rents in order to seduce tenants.

In the first quarter of 2010, it appears that there has been a stabilising trend in the commercial, real-estate market, following on from the final quarter of 2009.

Whether or not this stabilising trend will continue is a matter of conjecture, at this point, but quite a number of bankers think otherwise.

The US unemployment level is known to be kissing the 10-percent level, consumer confidence in both the US and Europe is at an abysmally low levels, High Street vendors in the US are in grave trouble, for the most part, because many households are keeping purse strings, tightly closed, and The Fed is considering new incentives to kick-start the economy, again.

At the Annual Meeting of the Southern Legislative Conference of the Council of State Government at Charleston, South Carolina, last Monday, Dr Ben S. Bernanke, the Chairman of the US Federal Reserve, said, inter alia:

> *'Our nation has endured a deep recession that in turn was triggered by the most severe financial crisis since the Great Depression. Today, the financial crisis appears to be mostly behind us, and the economy seems to have stabilized and is expanding again. But we have a considerable way to go to achieve a full recovery in our economy, and many Americans are still grappling with unemployment, foreclosure, and lost savings.*
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> *'The recession – as all of you know too well – has also battered the budgets of state and local governments, primarily because tax revenues have declined sharply. Many states and localities continue to face difficulties in maintaining essential services and have significantly cut their programs and work forces. These cuts have imposed hardships in local jurisdictions around the country and are also part of the reason for the sluggishness of the national recovery.*
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> *' … The housing market has remained weak, with the overhang of vacant or foreclosed houses weighing on home prices and new construction. Similarly, poor economic fundamentals and tight credit are holding back investment in nonresidential structures, such as office buildings, hotels, and shopping malls.*
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> *'Importantly, the slow recovery in the labor market and the attendant uncertainty about job prospects are weighing on household confidence and spending. After two years of job losses, private payrolls expanded at an average of about 100,000 per month during the first half of this year, an improvement but still a pace insufficient to reduce the unemployment rate materially. In all likelihood, significant time will be required to restore the nearly 8-1/2 million jobs that were lost over 2008 and 2009. Moreover, nearly half of the unemployed have been out of work for longer than six months. Long-term unemployment not only imposes exceptional near-term hardships on workers and their families, it also erodes skills and may*

have long-lasting effects on workers' employment and earnings prospects.

'… However, many banks continue to have a large volume of troubled loans, and bank lending standards remain tight. With credit demand weak and with banks writing down problem credits, bank loans outstanding have continued to decline. Small businesses, which depend importantly on bank credit, have been particularly hard hit by restrictive lending standards. At the Federal Reserve, we have been working to facilitate the flow of funds to creditworthy small businesses …'.

That, just about, says it all, doesn't it?

The Trigger

The crisis in the US with regard to securitisation of residential, real estate was driven by extensive debt refinancing.

The world is, still, feeling the *'heat'* in that regard.

But, perhaps, that which has not yet struck home is that the deterioration in the commercial, real-estate market drove up the LTV Ratios, resulting in lending standards, having to be tightened, considerably.

To press home this point, if the LTV Ratio of a commercial property is approaching 75 percent and, simultaneously, there is a material softening in the commercial, real-estate market, say to the extent of about 20 percent, to where does the lender go for honey?

Far-reaching problems come to the surface in respect of **TARGET**'s suggestive scenario which, unfortunately, is only too real as many bankers have discovered, over the past year or so.

The problems come to the surface not just for investors, but also for lenders – banks and finance houses.

Equity deficiencies result in widespread defaults, as one saw in the residential, real-estate markets of many parts of California in 2008, in particular, when households, realising that the market value of their homes was considerably less than the purchase price and, in the realisation that the mortgage payments were strangling the family budget to a point where it was too painful to allow the situation to continue, many households just packed their bags and left the property to the bank/finance houses.

It is estimated, today, that about 65 percent of all commercial, real-estate loans, on the books of banks or finance houses, will have exceeding difficulties in obtaining refinancing at the maturity of their contracts.

This is not just a US problem because, in Europe, the situation is bordering on a crisis, not seen for many a year.

In Spain, Portugal, Greece, Ireland and even in the United Kingdom, banks are looking askance at their precarious situations.

Only recently, The Council of Mortgage Lenders, an industry body, representing mortgage lenders in the **U**nited **K**ingdom (UK), its members, comprising banks, building societies and specialist lenders and representing about 98 percent of all mortgage lending in the UK, said that some British lenders have determined not to lend money on purchases of real estate in the UK because of the difficulties involved.

For foreign investors, wanting to move into real estate in the UK, unless they can put up 100 percent of the purchase price of a piece of property, they will find it tough going, trying to raise finance, domestically.

Many High Street banks and building societies have just closed their doors on prospective, foreign buyers of real estate in the UK.

Today, it is fact that mortgage lending in the UK is less than 50 percent than it was just 3 years ago.

And, for next 5 months of 2010 and for the entire 2011 year, mortgage lending in the UK is expected to shrink even further.

Banks and finance houses are continuing to be squeezed as lending rules tighten ever tighter.

Prices of real estate in the UK, therefore, are fully expected to drive to much-lower levels if this situation continues as is, presently, being forecast.

There was a time, back in 2007, when banks and building societies would entertain lending more than 100 percent of the market value of a piece of property in the UK to an owner occupier.

Those days are relegated to history.

Many UK banks are sitting on mountains of bad or doubtful loans, once thought to have been fully secured by real-estate investments.

Banks, today, realise the vast difference between a secured loan and a good loan.

As is only too obvious, the above situation is not just a potential microeconomic dilemma, but one of macroeconomic proportions.

The direct implications inculcate:

1. If the market values of commercial real-estate in the US and Europe continue to decline, or if delinquencies rise, materially, it will affect the construction industries of both territories, resulting in even more unemployment. The immediate result will be even further reluctance by lenders to put their money at risk in new building projects since the default risk increases; and,

2. Write-downs and write-offs of the market value of commercial real-estate and/or defaults by borrowers will hit the pockets of investors and the value of equities, sooner or later, will be eroded, materially. As the deteriorating wealth-effect takes hold, other crises are certain to the surface.

The US recession that had its roots in December of 2007 is, still, sadly, being felt, internationally, but many of the gigantic problems, left in the wake of the recession, are yet to have tackled, adequately.

The simple fact is that the backbone of any economy is demonstrated, inter alia, by the value of its real estate: If real estate values continue to deteriorate, so does the economy.

Tackling this problem would appear to be very high on the list of priorities.

Interestingly enough, Dr Alan Greenspan, the former Chairman of The Fed, always maintained that tackling the ticklish situation in respect of the real-estate market of the US was the key to returning the US economy to health.

How right he was.

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