COLUMBUS
BUSINESS FIRST
THE CENTRAL OHIO BUSINESS AUTHORITY
VOL. 25, NO. 31 MARCH 27, 2009

Brewing commercial real estate storm has investors taking precaution

VIEWPOINT

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As any seasoned boater knows, regardless of the forecast, keep your eye on the skies and take precautions before a storm hits.

Few would dispute that we ignored the impending residential real estate crisis. As a consequence, the nation's financial system suffered unparalleled damage as a result of consumer defaults, mortgage foreclosures and diminished property values. Unfortunately, another storm looms. This time, the threat relates to commercial real estate and the owners of commercial mortgages.

And banks are less likely to be the only victims. Rather, pension funds and insurance companies are also in the storm's path since they appear heavily invested in commercial real estate mortgages.

Unlike residential mortgages, where terms range from 15 to 30 years with monthly principal reduction, commercial mortgages generally have shorter terms, usually five to 10 years, and in recent years often provided for no principal reduction. Analysts estimate $20 billion in commercial mortgages covering office buildings, hotels, condominiums, apartments and retail properties will come due during 2009. The dollar value of mortgages coming due in 2010 and 2011 is projected to be even higher.

The owners of these properties will face challenges when trying to refinance their debt. In particular, owners of retail space are likely to encounter the greatest difficulty refinancing.

As consumer spending has waned, retailers are suffering. As stores go dark and rent payments stop, the income stream dries up for the owner of the retail property. As a consequence, the owner's ability to pay the mortgage and, more important, to refinance the mortgage is in jeopardy. And if, as is likely to be the case, the property owner defaults, the balance sheets of those businesses invested in commercial mortgages are at risk. Shareholder and pensioner wrath will not be far behind.

Prudent holders of commercial real estate mortgages will take immediate steps to protect their investments. If you hold a portfolio of commercial real estate mortgages, here are things to do now:

• Identify the type of property underlying the mortgages in your portfolio. Out-parcels and big-box retail space may be the most vulnerable, though condos, particularly in overdeveloped regions, are at risk. Next, determine whether you are a direct lender, as many insurers will be, or an investor in a pool of mortgages, as many pension funds are. If you are invested in a mortgage pool, then a servicer is likely involved. If so, review the service agreement and make sure you understand your rights and obligations. If you are a servicer, review your responsibilities in respect to nonperforming loans, particularly when you are required to transfer a loan to a special servicer. A special servicer steps in when a loan defaults.

• Dust off offering documents and ascertain whether there were any misrepresentations or omissions of material fact. These might form the basis for a claim against the promoters and sellers of the mortgage pool.

Any investor in commercial real estate mortgages will want to determine whether there is credit insurance protection or some other credit enhancement that may offer protection in the event of a default. This may provide protection limiting the damage to your mortgage portfolio.

• As lenders resurrect their risk management policies, they are unlikely to finance risky commercial retail space. Consequently, retail space that is already dark is likely headed to foreclosure. In that event, have a plan in place.

• Pension funds and insurance companies typically lack experience as landlords. Weigh the risk for acquiring the property against the rewards. Cities, particularly in areas ravaged by foreclosures and declining property values, are using public nuisance laws to hold owners of vacant and foreclosed property liable for the upkeep of those properties. Failure to maintain properties brings daily fines.

• If your company is substantially invested in commercial real estate mortgages, consider divesting a portion, or even all, of the portfolio. Private equity investors, who are creating distressed equity or vulture funds, may be an option.

A company might consider whether there is any advantage to creating a separate subsidiary to manage those mortgage assets as workouts and foreclosures work their way through the system. An alternative to a new subsidiary may be to create a special asset group to manage your mortgage portfolio. While some companies might prefer to off-load the distressed mortgages to a special purpose entity, that option probably isn't available because in today's financial environment, the prospects for adequately capitalizing any special purpose entity are remote.

All storms pass, as this one will too, and many mortgage investments may regain their value. In the meantime, a storm looms. The question is, are you prepared to weather it?

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