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Discounts? Yes, but a Fire Sale? No

Commercial Real-Estate Debt Hasn't Tanked Because So Many Are Seeking Bargains

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The massive market for debt tied to commercial real estate is beginning to thaw as investors flush with cash are starting to buy up billions of dollars in mortgages and securities that had been stuck on the books of banks.

But that doesn't mean banks are lending -- capital-starved real-estate owners and developers have yet to see relief. As a result, the market for office buildings, shopping malls and apartments remains largely shut down.

At the same time, investors are buying up mortgages and securities at discounts ranging from 5% to 20%, which is much less than the big discounts that vulture investors got in the wake of the last major real-estate collapse in the early 1990s.

"Banks are not moving their inventory at fire-sale prices," said Noble Carpenter, head of loan sales at Jones Lang LaSalle, a Chicago real-estate brokerage and management firm.


Part of the reason is that default rates on commercial real estate remain low by historical standards. But there is also a glut of capital that was raised to buy distressed debt. As a result, many funds may not be able to achieve the low- to mid-teens returns they're targeting -- especially if they can't borrow money to magnify their returns, according to market participants.

Banks' commercial-debt problems began last summer when the credit crunch prevented them from packaging and selling some \$200 billion in loans on properties such as skyscrapers and shopping malls as commercial-mortgage-backed securities, or CMBSs. Since then, bargain-hunting investors have been willing to buy at fire-sale prices, but banks haven't been willing to unload at that level.

Now, lenders are increasingly selling that debt, both as whole loans and as CMBSs. Buyers also are coming forward because of growing trading volume of CMBSs in the secondary market, reducing the spread between the securities and U.S. Treasuries.

In the past four weeks, banks have gone to market with four CMBS issues, with a total balance of \$4.9 billion, according to data provider Commercial Real Estate Direct. That is a dramatic improvement from early this year, when weeks went by without a deal, but it still pales next to the same period last year, when the issuance totaled \$78.7 billion.

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"It's anticipated that, industrywide, inventory will be way down by the end of the second quarter," said Steve Kantor, co-head of global securities and of alternative investments at **Credit Suisse Group**.

Among the notable reductions: **Lehman Brothers Holdings Inc.**, which had \$36.1 billion in commercial mortgages and CMBSs when its fiscal first quarter ended Feb. 29, sold roughly \$5 billion of the debt just in the following two weeks. Credit Suisse sold roughly \$5.5 billion of commercial property loans and CMBSs in the first quarter, which helped cut its inventory by 25% as of March 31. **Wachovia Corp.**, another big lender, sold \$4.2 billion of debt in the quarter, reducing its exposure -- after the effect of offsetting transactions, or hedges -- to \$3 billion as of March 31, down from \$7.6 billion at year end.

Yet the discounts these lenders are offering are anything but generous. During the real-estate collapse of the early 1990s, some commercial debt sold for pennies on the dollar. Back then, though, the default rate was more than 20% and distressed funds didn't start buying huge blocks of assets, primarily from the government's Resolution Trust Corp., until more than a year into the crisis.

Today there are already at least 55 active or planned commercial real-estate debt funds seeking to raise \$33.8 billion, according to Real Estate Alert, a trade publication. And many have begun to do deals.

Guggenheim Partners LLC's \$1.25 billion real-estate debt fund, raised in December, has so far closed on or committed to more than \$2 billion of investments. Edward L. Shugrue III, manager of real-estate debt funds for the firm, said the fund recently purchased \$100 million of investment-grade CMBSs backed by office buildings formerly owned by Equity Office Properties -- at discounts ranging from 10% to 15% -- from a liquidating investment vehicle affiliated with a foreign bank.

Fund managers believe they will still be able to hit their return objectives because most of the real estate underlying the loans is healthy. (The national default rate on commercial mortgages is a slim 0.4%.) Eventually, they hope, that will drive up the value of the debt. But the risk is that a serious economic downturn could drive up delinquency rates.

"We only take on risk we know how to manage," said Bradford Wildauer, a partner who heads the debt investing business for Apollo Real Estate Advisors. The debt fund that the firm closed a year ago, with \$625 million in equity capital, has so far committed to about \$900 million of investments.

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