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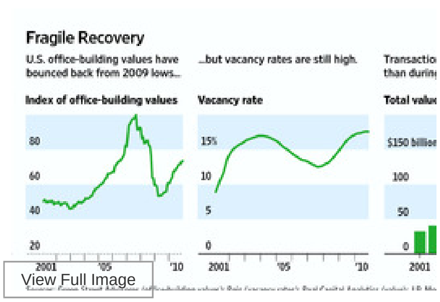
Commercial Real Estate Coming Back, but Unevenly

By ANTON TROIANOVSKI

Commercial property took less of a drubbing than residential real estate in the recession but still faces a long and painful recovery.

Banks have already taken $80 billion in commercial-real-estate losses—about half of what they are expected to take as a result of the recession, according to the Federal Reserve.



But in some markets, commercial-property values have soared more than 30% from their lows in 2009, according to one industry gauge. For properties such as marquee apartment buildings in New York City and office buildings in Washington, D.C., values are even approaching pre-crash levels.

Last week, a Washington building that had been the headquarters of the Mortgage Bankers' Association sold for $101 million—just a year after the trade group sold the 10-story building for $41.3 million. Even in hard-hit Atlanta, a major developer closed on a skyscraper last month in a deal that approached values last seen in 2007.

A year ago, Elizabeth Warren, who headed the congressional panel overseeing the Troubled Asset Relief Program, predicted a "tidal wave of commercial-loan failures." On Friday, at a follow-up hearing on commercial real estate held by the same oversight panel, Patrick Parkinson, a Federal Reserve official, said that "worst-case scenarios are becoming increasingly unlikely."

But commercial-property values aren't climbing uniformly across the country. Many suburbs and smaller cities, especially, are dotted with buildings that are no longer generating enough cash to pay their mortgages. Such problems have been a factor in driving up the delinquency rate on commercial-mortgage-backed securities, or CMBS, to a record 9.34%, compared with less than 1% in 2007.

Many other properties have rebounded in value but are still worth less than their mortgages that were taken out at the height of the boom. Last week, five resorts hobbled by high leverage taken on in 2007 sought bankruptcy protection as about $1.5 billion in debt came due. Among the properties are the Arizona Biltmore hotel in Phoenix and the Doral golf resort in Miami, according to court documents.

A closer look shows the rise in values doesn't reflect a strong improvement in rents and vacancy rates. In fact, the vacancy rate of the country's four billion square feet of office space is still near a record 18%—a level that translates into about 250 empty Empire State Buildings. Rents have been bouncing along the bottom, according to research firm Reis Inc.

Rather, investors are bidding up property values largely because of low interest rates, which have made financing less expensive and made competing income-producing investments, such as bonds, less attractive to yield-hungry investors. In addition, the government has encouraged banks to avoid fire sales and instead work with borrowers to modify bad loans. As a result, the market hasn't been flooded with foreclosed assets for sale.

But the availability of financing—the lifeblood of real estate—remains uneven. The volume of new CMBS issues, which plummeted in 2008, will be about $45 billion in the U.S. this year, according to a projection by J.P. Morgan Chase & Co. That is well above last year's $10.9 billion, but far below the $228 billion in 2007.

Also, some warn that an increase in borrowing costs could send values south again. "The minute interest rates go up, the game changes," says Chicago real-estate investor Sam Zell.

Mr. Zell built up the biggest publicly traded empire of office buildings in the history of commercial real estate. In 2007, he sold that company, Equity Office Properties Trust, to Blackstone Group LP for $39 billion in the biggest leveraged buyout that real estate had seen.

But Mr. Zell says there's no way he would try to create another national office empire. Rental rates and occupancy will be very competitive for the next four years, he says, and because interest rates are bound to go up eventually, "you're going to have a tough time producing the kind of yield necessary for the cost of capital."

For the commercial-real-estate recovery to gain steam, fundamentals such as rents and occupancies have to improve. That means the economy needs to generate more jobs than the 36,000 tally for January. Demand for office, retail and warehouse space will probably remain weak until hiring improves.

In top markets, where fundamentals are stronger, investors will likely continue to bid up property values. But stress from the boom-era bingeing will likely take years to work its way through the system. A Federal Deposit Insurance Corp. official, Sandra Thompson, said at Friday's hearing that excessive commercial-real-estate lending, which played a major role in the more than 300 bank failures since early 2008, is still weighing down community banks.

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