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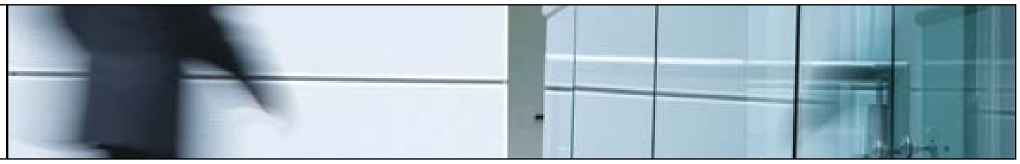


Tale of Two Markets

November 2011

By all indicators, the U.S. economy will continue riding a "recession-recovery roller coaster" into 2012. The banking industry's woes are well known, and of course, the recovery requires a solvent and competitive banking sector – we all remember TARP. Less publicized is the distinct impact the lending practices of the banking industry have made on the commercial real estate segment, in particular as it relates to investment by institutional players and REITs.

Indeed, as commercial property demand rebounded during the first three quarters of 2011, we saw a "tale of two markets" unfold: One "market" lifted by institutional transactions in primary metro areas. The other "market" depressed by community banks' bloated portfolios of distressed properties everywhere else.

Land of unequal opportunity for CRE recovery.
By September 2011, overall commercial real estate sales of $143.5 billion had already surpassed the full-year 2010 total, according to Real Capital Analytics Inc. (RCA). This rebound story was true primarily in core metropolitan areas, such as New York City, San Francisco and Washington DC, where capital sought out the best quality stabilized assets, particularly multi-family, and where cap rates and purchase prices neared pre-recession levels. The rest of the country tells a different tale.

In distressed markets, fundamental demand for space has still not returned. Recovery in smaller markets is also constrained by less availability of institutional capital – i.e. commercial mortgage-backed securities (CMBS). The domestic CMBS market imploded from a record $230 billion in 2007 to a mere $11.5 billion in 2010. For the ten months ending October 2011, total domestic CMBS issuance totaled $27.7 billion. Industry experts are already jittery about 2012 with issuance estimates ranging from only $20 to $35 billion. This uncertainty has meant fewer bidders and lower offers in secondary markets such as Minneapolis; Austin, Texas; and Raleigh, North Carolina, according to CBRE Group Inc., the largest global commercial real estate brokerage firm. CBRE reports there have been fewer bidders and lower offers, and CMBS conduits have been important in making deals in primary markets.

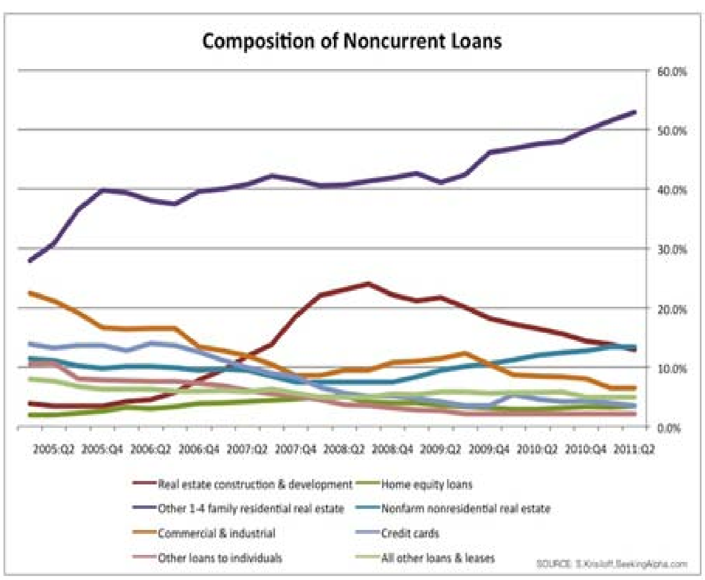
Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

We believe this "tale of two markets" pattern will persist into the coming year. Even as commercial real estate property-level fundamentals continue to improve, deals will flow to choice tier-one markets and only for select property types. In secondary and tertiary markets, only highly scrutinized and handpicked property types will attract financing.

"Banks' unresolved distressed loan portfolios will delay a full-fledged commercial real estate recovery," acknowledges Jack Mullen, Founder of Summer Street Advisors. Mullen believes 2012 is the year for banks to become more proactive in cleaning up their balance sheets. "Banks need to get back to the business of CRE lending, but it can't be business as usual, especially outside of core markets," says Mullen.

CRE banking faces tough reality.
As levels of uncertainty wax and wane for the foreseeable future, how should distressed CRE assets and loans be addressed so banks can start getting back to lending? To answer this, we first need to recognize that the banking sector is still far from the stability and liquidity of past economic expansions.

- FDIC data for 2010 shows mergers absorbed 197 banking institutions, while an additional 157 failed – the largest annual number of failures since 1992, when 181 institutions closed. Through the first half of 2011, FDIC records 48 bank failures (2 absorbed by mergers), and identifies 865 more "problem institutions" with $372 billion in assets. (See Chart Below)



- The rate of banks' non-current loans and loan losses has been declining steadily since the end of 2009. However, $320 billion in distressed loans remain on the books, and almost 20% are CRE loans.

- 40% of all bank loans are CRE loans, and small commercial banks hold almost two-thirds of that total, according to the Federal Reserve Board.

"This situation with smaller, community and regional banks can't be underestimated," offers Mullen. "They are living the tale of the geographic markets that the 2011 CRE rebound didn't reach. And when a local economy has tanked, some properties can't be liquidated at any price."

Can banks compete?
During 2011, Fitch Ratings, Inc. reported that commercial real estate financing commitments by life insurers (such as MetLife and Prudential) grew sharply, with second quarter commitments at $15.7 billion compared to $5.9 billion during the same period in 2010. Recent insurance mortgage deals have averaged about $20 million, with average LTVs around 60%, according to Fitch.

"Insurance companies enjoy a cost of capital advantage as well as reduced execution risk vs. banks. These factors favor insurance-financed CRE deals," says Mullen.

For real estate investment trusts (REIT), the participation of insurance companies in secured lending during the financial crisis ensured access to capital at a time when refinancing needs were substantial and unsecured borrowing costs exceeded 10% for even the strongest credits. Although REITs do not face large scheduled maturities in 2012, the continuing participation of insurers as lenders will provide critical support to the market.

Economic recovery always moves through a period where astute investors find opportunities to acquire assets at a discount. The coming year may very well be a good time to invest, with a large number of troubled loan portfolios from community banks likely to come to market in 2012. Banks, especially the smaller ones, may not realize how critical valuation and due diligence are to competing successfully.

"Institutional equity is accustomed to having transparency, and that aspect is often missing from community bank assets. Standard underwriting and valuation alone will not be sufficient to reveal the nuances investors need to know on a transaction. Every deal needs to be carefully reviewed," advises Mullen.

Many institutions may still face the worst days of the downturn as some figure out how to stay solvent, while others try to make money on commercial real estate while their local economies are still suffering.

"We need to understand and appreciate that a lot of small, community banks are in unfamiliar waters, and there's genuine fear about what's going to happen. But they will have to move past fear and trust professionals that have done this before to help them," recommends Mullen.

Get back to fundamentals.
Despite economic uncertainty, the principles of sound finance have not changed. While it won't be easy, distressed banks have an opportunity to move forward with back-to-business plans based on fundamentals. A prudent course suggests three imperatives:

- First things first: clean up the balance sheet.
- Second, banking executives have to step forward with a new vision to attract capital based on good market analysis and lending practices.
- Finally, if the numbers dictate, some leaders will be called to shutter their organizations – many community and regional banks will only remain solvent through merger or acquisition.

"Right now, banks are a risky investment," Mullen emphasizes. "Every bank needs a viable business plan, one that makes sense for its investors."

Banking executives can do more than any other group to move their industry forward, starting with due diligence – and the realization that the future may never again look like the past.

More on this topic: Know What You Don't Know: The Unique Challenges of Community Bank Distressed Debt Portfolios

Summer Street Advisors LLC (SSA) is a commercial real estate and financial services advisory firm. SSA offers a rigorous, data driven approach in providing commercial real estate and loan investment valuation and analysis, transaction due diligence, bank and REIT advisory, asset/portfolio management and loan underwriting.

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