

Experts predict tough times for commercial landlords

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So far, commercial real estate has avoided the massive mortgage defaults that have hit homeowners, even though San Diego County offices, shopping centers and hotels saw similar surges in prices over the past few years.

But experts are beginning to talk about possible tough times ahead for commercial landlords, particularly as building owners try to refinance maturing debt in today's tight-fisted lending environment.

At a conference in San Diego yesterday sponsored by Trigild, a San Diego company that manages troubled projects for lenders, experts talked about the prospects of rising loan defaults for income-producing property, such as offices and shopping centers.

Their conclusion was that more strain is likely for the next year or two. Commercial projects tend to lag the overall downturn in the economy, so it's only now that they are starting to be hit with higher vacancies.

"We're just seeing the beginning of it," said Thomas Deane, head of structured transactions and special assets for Wachovia Securities.

One example of this early stress in San Diego is Cosmopolitan Square, a 39-story hotel-condo project proposed near Petco Park.

Despite having a trendy Mondrian hotel in its plans, Cosmopolitan Square developers lost the full-block site downtown to foreclosure last week when they failed to find a lender willing to provide a bridge loan to get the project off the ground.

For now, though, overall defaults among commercial real estate borrowers remains low. For commercial mortgage-backed securities – pools of mortgages bundled into bondlike investments – the delinquency rate is well under 1 percent, said Henry Bieber of Wrightwood Capital in Chicago.

"Commercial real estate has performed reasonably well and has a reasonably low level of default," said Kevin Donahue, a senior vice president with Midland Loan Services of Overland Park, Kan.

But some commercial landlords and developers could face a complex set of problems going forward, these experts said.

For one, the market for commercial mortgage-backed securities has dried up in the wake of the credit crisis. At one time, these securities provided debt financing for about 40 percent of commercial real estate deals, experts said.

Those lenders that are left, mainly commercial banks, insurance companies and pension funds, have tougher lending standards today than they did during the boom, experts said.

In addition, landlords who purchased buildings in the past couple of years sometimes paid sky-high prices. Their plans called for boosting rents and occupancy to justify what they paid.

With a weakening economy, however, rents are flat and vacancies are on the rise in many parts

of the country, including San Diego.

Finally, some commercial properties aren't worth as much today as they were during the boom, experts said. Back then, buyers of offices, for example, would sometimes accept a capitalization rate as low as 5 percent. The so-called cap rate – net operating income divided by the purchase price – is a common way of valuing commercial real estate.

Today, buyers generally want cap rates approaching 8 percent for offices, real estate experts say. So an office building that was worth \$1 million at a 5 percent cap rate two years ago would be worth \$625,000 at an 8 percent cap rate today – given the same operating income.

That could create a problem for a landlord who needs to refinance a building with a lot of debt.

Real estate experts said properties showing signs of distress today are older retail and apartment buildings in poor locations. David Iannarone, managing director of CW Capital in Washington, D.C., said regions hit hardest by the housing and automotive downturns seem to have the most problems with commercial loans, such as Detroit and parts of Ohio, Nevada and Arizona. "California has been relatively quiet," Iannarone said. "I'm not sure that's going to last."

Experts were concerned that retail landlords would begin to suffer after what's expected to be a bleak holiday shopping season.

"I think retail is the next to go," said Deane of Wachovia Securities. "Then office is not too far behind."