



commercial real estate  
with a

**Credit Point of View**



*Those of us schooled in the discipline of credit often have a different take on what is going on in commercial real estate. We thought it would be helpful to share our perspective on the market - and perhaps provoke some thought, discussion and insight. In these posts, Gunnar Branson sits down with Wrightwood Capital executives and examines the implications, the insights, the opportunities and the risks that can be understood from a "credit view" of Commercial Real Estate.*

## **does extend mean pretend? six challenges to conventional wisdom**

Just as the most brilliant among us have made decisions at the height of the bubble that we might want to take back, some unexamined assumptions may cause us to miss what is actually taking place.

In recent conversations with Bruce Cohen, CEO of Wrightwood Capital, he expressed his frustration with one industry premise in particular; as he put it, "Everyone points to 'extend and pretend' as the source of market paralysis and yet few are really thinking through the assumptions inherent in that phrase. Banks are certainly extending terms on loans, but is that pretence or a prudent strategy for recovery?"

Bruce's point is well-taken, but his is a lonely voice these days. The conventional wisdom is that regulators and bankers are, at worst, preventing recovery and, at best, slowing it down. "Extend and pretend" has been repeated like a drumbeat in financial pages, congressional testimonies and trade events by brokers, television pundits and hopeful private equity investors since the beginning of this recession. They believe that the market is held in stasis by owners and clueless lenders who are unwilling to accept reality and to sell assets at a loss. Many make the argument, "If only banks would force more defaults for their troubled loans, accept their losses and liquidate, then private equity could buy assets at a discount and restart the market."

Many critics, including reporters Carrick Mollenkamp and Lingling Wei in their recent Wall Street Journal article, ("**To Fix Sour Property Deals, Lenders 'Extend and Pretend'**" - July 7, 2010), worry that, "rampant modification of souring loans masks the true scope of the commercial property market weakness, as well as the damage ultimately in store for bank balance sheets."

There may be examples of asset managers in denial, as were cited in that article, but there is also a strong case to be made that at a macro-level there is very little pretending going on. The notion of clueless banks is a favorite cliché, and it is possible that the corrosive effects of large bureaucracies with access to nearly free capital from deposits can lead to some cognitive laziness, but are they **pretending**?

According to Bruce, "Most of the banks know exactly what they are doing – extending is the most rational, most fiscally responsible strategy for them to take at this point in the cycle. Is it reasonable to assume that lenders don't understand or are unwilling to acknowledge the loss of value in their portfolio? By extending the term of troubled mortgages, are they hoping or even praying for some sort of deus ex machina event? Are they only delaying the inevitable loss? I don't think so."

Maybe bankers are smarter than they have been given credit for, "Perhaps by extending maturities, they are protecting their portfolios, their depositors, their borrowers, the tenants and, ultimately, the entire real estate community. Done correctly, extension strategies can help build a foundation for a market recovery," said Bruce. "It is a prudent strategy based on a clear assessment of their current portfolios and their best opportunities for recovery."

But it is difficult to put aside the myth of clueless bankers. And the chorus of complaints seems reasonable when it declares that the "pretense" of extended loan maturities is slowing down the necessary deleveraging, re-pricing and re-starting of commercial real estate activity. To answer those complaints, Bruce laid out the following six challenges to the conventional wisdom of "extend and pretend":

**1. Most financing provided by commercial banks is more than the extension of credit,** it's an investment in a business plan. The investments made in 2007 and 2008 have had their strategies delayed, not necessarily invalidated by the recession. Lenders are rational to give more time for the business plans of those real estate businesses (aka properties) to be executed and for tenant demand and property values to rise again. As businesses get back to business, they will need more space to do it. In an economy as massive as the U.S., real estate demand must grow – and this is already playing out. Despite a slow recovery, leasing activity is picking up and space is getting leased, albeit at lower rents. As a result, previously underperforming assets are seeing their values increase through increased occupancies and net operating income.

**2. Not "extend and pretend" – Extend and MODIFY.** Extending is not a passive avoidance of a problem, it is the first step in a smart and orderly process that drives towards an ultimate realization. A foreclosure proceeding is difficult, expensive, and may take in excess of 12 months to complete. There are many ways to lose additional asset value during that time. In exchange for an extension, lenders are modifying their loan agreements – by requiring the borrower to put the title in escrow or give up rights to defend foreclosure, and obtaining additional capital – all to gain tools to make the process faster and reduce their exposure to adverse outcomes. Extending, then, is a way to facilitate and accelerate the banks efforts towards ultimate recovery.

**3. Liquidating now hurts banks' ability to make new loans.** A large part of the argument for banks to stop extending their loan maturities revolves around the notion that if they recognize these losses,

the banks will be able to resume lending. Unfortunately, most people making this argument overlook the multiplier effect of leverage. For every dollar of capital on banks' balance sheets, they typically lend \$10. Conversely, a reduction of a bank's capital base, due to recognized losses, will lead to a similar multiplier effect that reduces the loans the bank can carry. In some cases, excessive writedowns will lead to a determination that those banks are undercapitalized and in the absence of new capital may be shut down. Generally, recognized losses will not lead to a resumption of lending, but rather, a material reduction in the amount of new loans that bank can make.


**4. The Bid-Ask Spread isn't caused by lender denial – it's from excessive investor yield expectations.** In the last 12 to 18 months, it has become apparent that investors' expectations were too high, especially in a low inflation, low interest rate environment such as we have today. Those expectations are now normalizing and transactions are starting to happen once more. Were the lenders and owners clueless when they didn't panic and sell at the bottom of the market? Or were private equity investors overly optimistic to think they would find massive discounting?

**5. The Resolution Trust Corporate (RTC) did not restart the real estate market in the 1990's.** Contrary to the popular mythology, the liquidation of the failed savings and loan portfolios was not the catalyst for real estate's recovery. Rather, it was the resumption of growth in the broader economy, coupled with the introduction of securitization to commercial real estate that allowed the industry to stabilize more quickly than expected. Consequently, the liquidation of large portfolios by the RTC into a recovering economy with accelerating capital flows merely led to one of the largest transfers of wealth from the taxpayers to private investors.

**6. The liquidation of bank portfolios doesn't serve the market, it serves the vulture.** Isn't it interesting that the loudest voices criticizing banks for holding on to distressed assets come from the people most interested in acquiring those assets? These new investors certainly perceive long-term value in commercial real estate. Should new investors be the only ones to realize the returns from the hard work of owners, operators and investors that have been in the market for years? Is it necessary to transfer the assets and the associated wealth to new entities simply because there has been an economic slowdown?

Consider the cost of foreclose to the lender and the community. During a lengthy foreclosure process, the asset frequently languishes and value is further reduced. When the asset is finally sold at a discount in a soft market, the values of neighboring assets are hurt as well – and the economic vitality of commercial districts takes yet another hit.

Foreclosure is often a strategy of last resort – as it produces a less than satisfactory outcome for the bank, the investors, the community, the tenants, and the owner...everyone except for the vulture investors who benefit from an aggressively discounted purchase of the asset.



If lenders wait before initiating foreclosure proceedings, the only way they will lose more money is if the property drops further in value a year from now. However, most people, including the hopeful vulture funds, believe the real estate market and each asset in that market will be worth more. If that's the case and if it is possible to wait, why sell now?

Who benefits from a forced liquidation? - new private equity investors

Who benefits from extensions?" - existing owners, tenants, depositors, lenders and the communities surrounding each troubled real estate asset

Is extending pretending? Or is it a rational response to a downturn? Bruce's six challenges suggest that we all need to re-examine our assumptions.

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