Deflation Risk On Income Property Permanent Loan And Investment Portfolios

by Marc R. Thompson, CRE

ABOUT THE AUTHOR

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Over the past 18 years, the author has observed patterns in large income property loan portfolios during both inflationary and deflationary investment cycles. An inflationary investment cycle is when rents-prices for investment properties are increasing in aggregate. This inflationary trend occurred in the San Francisco Bay Area Tech Boom period from 1997 through 2000. A deflationary investment cycle is when rents-prices for investment properties are declining in aggregate. There is significant evidence to support a deflationary trend in the San Francisco Bay Area investment properties commencing 2001 with a 3- to 5-year duration.

INVESTMENT PROPERTY MARKETS ARE CHAOTIC

Income property portfolios react similarly to chaotic or non-predictive patterns in other investment portfolios such as stocks and bonds. The primary difference is that the time of change is very slow as measured in years in income property loan portfolios compared to the more volatile stock or bond portfolio reaction measured in days. This time difference is rather large since it typically takes 6 minutes to sell a stock versus 6 months on average to sell an income property. These "sell times" are averages from the point an investor decides to market an investment to the time net proceeds are received. Further, income prop-

erty transaction times extend or contract depending on market conditions. Historically, income property is considered a safe, predictive investment alternative compared to the more volatile-chaotic stock or bond markets. Investor winners and losers are measured daily in the stock and bond markets, while income property portfolios are measured over years. Income property investments move so slowly that most investors believe it is predictable. Since the average "sell time" takes six months, deflationary pressures can have a significant negative impact on income property investments held over long periods of time. Predicting when or if deflation will hit a market is debatable between buyers and sellers. As it takes about 6 months to get out of a property, investors display a propensity to hold on longer during the beginning of deflationary cycles. Therefore, when it is time to sell, most investors have waited too long to capture the sales gain at the market top. Most investors discover when the top of the inflationary market occurred after they are already on the investment cycle's down slope. When investors in aggregate believe it is time to sell, it is often too late as the top of cycle has already occurred. When investors try to sell on the down slope with vacancies increasing and with downward pressure on rental rates, it is very difficult sell since buyers typically have an uncertain outlook and are waiting on the sidelines for lower purchase prices. Spieker Properties, with the benefits of hindsight, selling to Equity Office is one example of a sale near the top of the inflationary cycle in February 2001. This transaction was observed by many CREs as the best-timed major income property portfolio sale in the San Francisco Bay Area marketplace.

INVESTMENT CYCLE PERIODS

Given the recent 10-year investment cycle (1991-2001) in the San Francisco Bay Area, the first 5 year-period through 1996 was in aggregate deflationary for income investment properties purchased or refinanced from the previous inflationary period--1986 through 1991. The last 5 years (1997 through 2001) was an inflationary period with rents/values in aggregate increasing on properties because of high demand for space related to the Tech-Boom economic expansion. Given existing lackluster demand with negative net absorption in the San Francisco Bay Area and given very high vacancy rates, the next five years will result for many property types deflationary pressures on rents/values for investment properties in aggregate. There will be exceptions. Some properties will not experience deflationary pressure in rents or investment sale prices because they have long-term leases backed by quality tenants occupying the entire property or are a "one-of-a-kind" superior location property.

INVESTMENT PROPERTY CAN BE ILLIQUID

Investment property real estate can be very illiquid when economic uncertainty is high. For example: buyers typically acquire income property if they project Earnings, Before Interest, Taxes, Depreciation and Amortization (EBITDA) being stable or having upside potential. Buyers will be out of the market if EBITDA growth is uncertain or has downward pressure due to negative economic data in the subject's market area or overall economic conditions. Income properties are an investment that can take years of financial hardship before recovering from a deflationary cycle experience. Many real estate investors lost their entire fortunes on income property investment alternatives over a ten year time period from 1987 through 1997.

SAMPLE SIZE

Income property loan portfolios provides for an excellent cross-section sampling of investment real estate pattern observations over many years of observation. Over a 10-year period from 1987 to 1997 on income property loan portfolios in excess of $4.5 billion, many of the negative risks of income property ownership were discovered including most of the product types, locations, and various forms of ownership risks. The statistically significant sample size provided a portfolio overview perspective that over time displayed deflationary investment cycle trends. The size of the loans that are at risk of deflation does not matter since many loans affected were in excess of $50 million with one at $250 million. These loans were just as prone to deflationary EBITDA and value pressures as were smaller loans. However, the smaller income properties were more liquid in terms of disposition since there is a larger pool of buyers at the smaller end of the property size scale.

HISTORY

The last deflationary cycle in income property permanent loan portfolios began in the Oil Patch States in 1986. The weakness in the income property markets then expanded to the Atlantic seaboard in 1989, and to the West Coast in 1991. The carnage of losses for all financial institutions was significant with the brunt of this deflationary income

property cyclical trend impacting savings and loan institutions. The Resolution Trust Corporation was created in 1990 by the U.S. government to liquidate the income property assets of banks and savings & loan institutions with federal tax payers funding the liquidation process.

THE LOS ANGELES METRO MARKET LOAN PORTFOLIO EXAMPLE

Income property investment trends, loan defaults by location, and resolution patterns in income property loan portfolios were observed working out problem loans in the Los Angeles Metro Area during 1991-1997. The region was impacted during a three-year period commencing in 1991 with negative economic news including a nationwide recession, significant regionally concentrated military cutbacks, social strife driven by the Rodney King riots and finally the devastating Northridge earthquake. Los Angeles County lost 340,000 jobs in the early 1990s which was the greatest number of jobs lost on a percentage basis since the Great Depression.[1] It was not uncommon to recover only 50% of the loan amount on apartment income property loans in several depressed sub-markets in the Los Angeles Metro Area during this period with investors losing their entire investment. Many income property product types—office, industrial, retail, apartments—incurring earthquake damage in combination with the negative economy recovered less than 50% of the loan amount and some recovered less than 20% depending on deferred maintenance or physical earthquake damage. As a result, the income property investors lost their total investment in these properties incurred significant tax recapture issues creating additional tax problems years after foreclosure. In addition, loans with recourse provisions required investors to pay settlement amounts out-of-pocket or pay attorneys to defend against protracted litigation initiated by the financial institutions.

During this income property deflationary period, income property loans that incurred the highest incidence of default were originated from 1986 through 1989 in this Los Angeles Metro Area marketplace. This origination time period experienced high inflation rates on rents and values. For example, one institution averaged $1 billion in loan originations each year during these inflationary years. This institution financed acquisitions or refinanced at higher leverage based on these inflated values. Many of these properties financed increased in value over 100% over this 4-year period.

From 1991 through 1996, a real estate advisory firm in contract with this institution, modified, received discounted payoffs, or foreclosed about $700 million each year. Unfortunately, because of the duration of the deflationary cycle in Los Angeles Metro Area, most of the 1991 and 1992 loan modifications went into default in later years converting to either a discounted loan payoff or foreclosure. In those 1991 and 1992 loan modifications, financial institutions required investors to pay additional out-of-pocket cash to reinvest into the property in return for the financial institution modifying the interest rate or terms. The idea behind this additional cash infusion requirement by an investor was to modify the debt only if the investor believed that it would receive its additional investment back if the loan was modified. Otherwise, it was best for the financial institution to foreclose and sell the property. This financial institution believed that a loan modification was unstable if there was no additional financial commitment by the investor which proved to be true as most of these loan modifications later defaulted.

As the deflationary period progressed (1993-1994), this financial institution realized that it was best to negotiate stable resolutions to problem loans since reworking loans previously modified was a flawed strategy that typically postponed losses. A stable resolution was a loan foreclosure or discounted loan payoff to a third party or a well structured loan modification with a substantial additional cash investment.

INCOME PROPERTY LOAN DEFAULT PATTERNS

At the beginning of the Los Angeles Metro Area deflationary economic period in late 1991, loan defaults and foreclosures occurred first on non-recourse loans. In a non-recourse loan, full loan repayment is not guaranteed by the borrower. The lender is relying upon the collateral as the sole source of loan repayment provided that no fraud or other recourse triggers are applicable. In this deflationary economic environment from 1991 through 1996, many investors experienced substantial decreases in Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) on most property types. Income property investors that had refinanced at maximum cash-out loan-to-value ratios or purchased their properties at the peak of the cycle from 1987 through 1990 were at risk of being over leveraged and less able to service

their debt as EBITDA began decreasing. These investors were unable to service their loan payments originally based on higher economic rents and loan underwriting at origination. These properties had high debt loads based on loan underwriting rental rates and occupancy rates based at the peak of the inflationary economic cycle. A telling sign of properties affected by overleverage in a deflationary period was the discovery of significant deferred maintenance since this expense was largely discretionary by the investor. However, this strategy by apartment investors - often shifted the property to a lower competitive position in the market place attracting only lower credit quality tenants resulting in higher turnover costs further decreasing EBITDA.

THE RECOURSE LOAN ARGUMENT

Later in the deflationary period during 1993, the weaker recourse borrowers fell victim to the length of the recession's negative economic cycle. As a common practice with some lenders in California, the recourse borrowers were sued (judicial foreclosure) for a deficiency between the loan amount and the lower appraised value. In California, a Trust Deed State, the common practice is to foreclose non-judicially within 120 days of a filing of a Notice of Default. However, even though recourse loans were pursued under a judicial foreclosure process, most, if not all, of the judicial foreclosure actions were abandoned or settled prior to going through the full extent of the judicial foreclosure process with these properties foreclosed non-judicially. These judicial foreclosure pursuits were abandoned because of business reasons of the financial institution filing suit, time/cost of the judicial foreclosure process, and primarily the California laws favoring debtors thereby reducing lender deficiency amounts. Many lenders pursued a parallel process of filing both a Notice of Default non-judicial foreclosure and filing judicially in conjunction with a request to appoint a receiver. Those borrowers with assets to protect responded well to judicial foreclosure claims resulting in more favorable results for the lender than just pursuing a non-judicial foreclosure action. The cost benefit analysis was in benefit of the lender in most cases providing a good return pursuing this legal action. In the property investment loan portfolio, there was a significant trend with the financially stronger recourse borrowers holding on longer and paying out-of-pocket debt service until they became financially exhausted later in the deflationary period. In addition, many very financially strong borrowers with recourse loans fed the negative debt service payments out of pocket throughout the deflationary period without going into default. There is a strong argument for full recourse provisions on investment property loans based on the good probability that many of these recourse loans will not go into default in deflationary economic periods. The portion of the investment property loan portfolio that had not experienced many defaults were loans originated prior to the inflationary peak of the cycle in 1985.

CURRENT INCOME PROPERTY PATTERNS

In today's income property loan portfolios, there is high deflationary pressure on office and "research & development" building rents-values due to historically high vacancy rates in the San Francisco Bay Area and Silicon Valley. For older stock class B and C apartments, new investment dollars are keeping prices stable or increasing as vacancy rates are increasing resulting from a lack of job growth. This appears to be a counter trend, however, it is only postponing potential investment losses for those investors who had purchased apartments at the inflated top of the market experienced in the past 3 to 4 years. There is deflationary pressure on apartments since 1997 as older stock class B and C apartments in most rental markets in the San Francisco Bay Area have doubled in price on a per unit basis. This is a similar trend observed in the Los Angeles Metro Markets prior to an extended deflationary period for apartments from 1991 through 1996. The luxury apartment market has dropped to 1997 rent levels in many markets from its 2001 highs. However, an important note, many new luxury apartments owned by Real Estate Investment Trusts had low vacancy because of corporate sponsored apartment units. After the Tech Bust in 2001, these corporate-sponsored apartments units went vacant and added to the supply of units over a short period of time increasing pressure to lower rents to shore up the vacancy. The luxury class A apartment market in the San Francisco Bay Area tech bust affected markets and were the first apartments to adjust to the deflationary apartment rental rate environment with rent rates declining up to 35% in 2001 and 2002. The probability of downward rent pressure on older stock class B and C apartments is increasing as a result of higher turn-over rates and lower credit quality of renters. In addition, apartment owners are faced with greater competition for quality renters as a result of high unemployment and a favorable financing environment for single family

homes through July 2003.

PROJECTED LOAN DEFAULT TIMING CYCLE

In today's investment property portfolios, most of the permanent loans originated in the past five years have limited recourse provisions. Once the full impact of the deflationary income property economic cycle is felt by lenders, it is probable that the default rate may climb higher within a shorter period of time than in the last deflationary economic cycle. This can be expected since there is less recourse debt to smooth out the default rate over a two- to five-year deflationary economic cycle period. Commercial mortgage-backed securities (CMBS) and savings bank loan servicers could see a flood of defaults on income property loans within a fairly short time period causing increased deflationary pressure on income property markets if these defaults turn into non-judicial foreclosures. If interest rates remain low, the carnage could be spread out over more time with a loan modification strategy. The probability of a stable loan resolution, based on a loan modification strategy in a long 3 to 5 year deflationary economic cycle, is not good based on experience from prior deflationary periods. If the CMBS markets or Savings Banks have a liquidity crisis forcing special servicers to liquidate defaulted income property loans to cash, the increased probability of further income property deflation could be as severe as the declining values observed in the Los Angeles Metro Area from 1991 through 1996.

There is a large negative investment impact of this potential deflationary cycle on the CMBS income property loan portfolios for a number of reasons. The CMBS market for income property loans is a new medium of financing income property loans and has not experienced a deflationary period in its short 10-year history as experienced in the early 90s with the savings and loan institutions. This risk appears to be real given that one large CMBS servicer's (confidential) default rate is twice as high as last year with its default loan rate climbing as of this writing. Also, Savings Banks have been expanding their loan portfolios in an effort to gain earning assets. Washington Mutual and California Federal (now Citibank) have been the leading apartment lenders in California. As with CMBS lenders, they may also be impacted by deflationary pressure risks when it becomes realized in apartments later in this deflationary cycle.

THE FORECLOSURE CLUSTER PATTERN

The most intriguing loan default pattern that emerged from observations of income property loan portfolios was of the emerging pattern of foreclosure clusters over a 3- to 5-year time period. Foreclosure clusters are the opposite negative pattern of the well understood positive pattern of development clusters. A development cluster is fueled by rapidly expanding enterprises such as the internet related business boom beginning in 1997 in Silicon Valley, Northern California, together with other areas of the country such as Austin, Texas, and Route 128 in the Boston Metro area. The development cluster grows as in a ripple effect as long as the synergistic economic positive driver remains strong. Think of a development cluster as a tornado lifting rents and investment prices higher and higher in ever bigger and bigger concentric rings influencing other areas for growth.

A foreclosure cluster forms when many random owners of loans foreclose in high concentrations within a sub-market or City during a relatively short period of real estate time ranging from 2 to 3 years. This pattern was observed for the first time in the Los Angeles sub-markets of North Hollywood, Van Nuys, and Northridge. Blocks of apartment units were in the process of being foreclosed within a 2-year time span by numerous independent lenders and owners of Resolution Trust Corp sold loan portfolios. The new owners of foreclosed apartments would buy these apartment buildings well below replacement cost at a discount of up to 50% lower than competing apartment owners. These competing apartment owners were disadvantaged since they purchased or refinanced at the top of the economic cycle in the late 1980s and were located at the fringe of the foreclosure cluster. The new owners of foreclosed property could reduce rents to attract tenants at a rate that would yield a profit, whereas the apartment owners on the fringes of this foreclosure cluster who were stuck with higher debt service payments could not compete and would default on their loans. The foreclosure cluster would grow as in a ripple effect with the apartment income property investors located on the outward fringes of the foreclosure cluster at risk of going in default as time passed. Think of a foreclosure cluster as a vortex pulling rents and investment values down the drain. This vortex will influence other areas as the outer rings of the vortex grows and brings other investment properties down with those investment properties rents and prices adjusted to the bottom of the investment market.

PREDICTING FORECLOSURE CLUSTERS

At the time of the writing of this article, Northern California, specifically the San Francisco Bay Area, is falling into a high probability of experiencing a foreclosure cluster pattern in many submarkets in 2004 and 2005. As in Los Angeles County in 1990, commercial office was the first to become weak in the deflationary economic cycle. In the winter of 2003, San Francisco Bay Area vacancies were in excess of 23% or up to 33% when including "shadow space" in Silicon Valley driving down rents to 1996 levels of $27/SF/year for class "A" office.[2] Luxury apartment rents are approaching 1997 levels losing 35% to 50% from their peak levels with average occupancies decreasing because of higher turn-over rates. Hotels are averaging 55% occupancy with downward pressure on rack rates. For example: many hotels were financed at a 75% loan-to-value based on peak average daily rates at occupancies in excess of 75% and with some hotels as high as 80%. Average daily rates have dropped significantly with EBITDA dropping to new lows increasing the probability of this property type falling in value as distressed hotel properties become more of a deflationary economic factor in the marketplace.

The San Francisco Bay Area building boom was in concert with the Internet interdependence/tech boom largely fueled by non-credit tenants directly bidding up the cost of office space for its businesses and apartment space for its employees. Unfortunately, in San Francisco, these non-credit tenants providing cash secured Letter of Credit lease deposits to lease space have forced out many long-term credit tenants out of San Francisco. When the "tech bust" occurred, many buildings leased by non-credit tech-interdependent businesses went vacant. In San Francisco, there is a 23% vacancy or 17 million square feet,[3] well over a 10-year supply by many accounts. Because of excess capacity of office and Research & Development buildings of well over 100 million square feet in the San Francisco Bay Area, there is a historical excess of capacity never experienced on such a large scale in the San Francisco Bay Area. As a result of this excess capacity, there is significant risk that any income property constructed, purchased, or refinanced at the maximum finance amount since 1998 has a significantly higher probability of a loan default. Properties that have mitigated market risk by leasing long-term to a high credit rated tenant are immune to this deflationary economic effect. This tech boom period had a significant building boom as evidenced by driving South from San Francisco towards San Jose. The amount of "For Lease" signs on new buildings is unprecedented at this scale in the San Francisco Bay Area.

As for apartments, Santa Clara County had for its first time recorded an out migration of over 12,511 residents in 2002.[4] Santa Clara County was the biggest development cluster driver of the Tech Boom creating a ripple effect through Northern California from 1997 through 2000. With out-migration, an unemployment rate of 8.4 percent,[5] and with contract jobs down 63% which are not counted by the State's Employment Development Department, the deflationary pressures on income property investments appear to be climbing in Santa Clara County. From December 2000 to April 2003, the Valley lost 17.4% of its jobs, the biggest drop from peak employment for one region since the Great Depression.[6]

CONCLUSION

Unfortunately, almost all San Francisco Bay Area income property investors are adjusting to deflationary EBITDA property performance or will do so soon. Income property loans originated since 1998 based on higher rental rates and occupancies have a great deal of risk of going into monetary default in an income property loan portfolio. This conclusion is based on direct income property loan portfolio experience and speaking with other income property loan portfolio managers as President of The Equity Asset Managers Association in San Francisco. This conclusion is based on observations and confirmations from other lender portfolio managers who have observed across the board declines in EBITDA due to the loss of commercial and residential tenants in many properties financed by San Francisco based financial intermediaries. The magnitude of this deflationary recession in Northern California income property real estate markets is significant enough to be concerned about a repeating pattern of foreclosure clusters within the next 2 to 3 years. Since Commercial Mortgage Backed Securities (CMBS) and other financial intermediaries have originated billions of income property loans from the peak periods of 1997 through 2000 in the San Francisco Bay Area, it will be interesting to observe if past foreclosure cluster patterns will again repeat as observed in the Los Angeles Metro Area from 1993 through 1996.