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The economy cannot withstand a material drop in asset values

By Jeff K. Davis

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Somehow since the Securities Exchange Act of 1934 was enacted with the requirement that registered companies file Forms 10-Q with the SEC, the quarterly report has evolved (or devolved) into an elaborate marketing process for Wall Street. Most actively traded registrants spend a lot of time with the Street to manage expectations, while the Street hypes expectations with clients; however, little changes within a 90-day time frame.

That will not be quite true in the recently completed third quarter. The increase in intermediate and long-term rates during May to July crushed mortgage banking earnings and highlighted why a highly cyclical business like mortgage banking should be awarded a low price-to-earnings when earnings are above trend. The same is true for fixed-income capital markets. The plunge in Jefferies Group LLC's fixed-income revenues to $33 million in the quarter ended August 31 from $266 million in the year-ago quarter was surprising only by its magnitude. Similar trends will be reflected in Goldman Sachs Group Inc., JPMorgan Chase & Co., Morgan Stanley, Citigroup Inc., First Horizon National Corp. and Raymond James Financial Inc. in their third-quarter reports.

In late April, Apollo Global Management LLC CEO Leon Black offered that it was a fabulous time to sell "everything that is not nailed down, and if we're not selling, we're refinancing." Federal Reserve Chairman Ben Bernanke's allusion to tapering of bond purchases in early May made Black look prophetic — at least with regard to fixed-income securities. Sam Zell basically did the same when he agreed to sell Equity Office Properties Trust to Blackstone Group LP in November 2006, noting that it was then raining liquidity.

Green Street Advisors Inc. reported that its commercial property price index rose 1% in April and in the process rose 1% above its 2007 peak. The index subsequently rose 3% in May and 1% in August and otherwise was flat in June, July and September. Green Street's index is value-weighted, so properties in New York, Boston, San Francisco, Los Angeles and Washington presumably are well represented in the index. Commercial real estate like high-yield and equities has been a big beneficiary of the Fed's policy of anchoring short rates at zero and suppressing long-term rates. The same is true for the aforementioned cities as finance and government hubs.

The counter-factual cannot be proven, but I wonder how much the Fed's policies have supported marginal assets that were not written-down during 2008-2011 or written down less than would have been the case absent a sharp drop in rates and a flood of liquidity. Bank earnings and capital have been a beneficiary of the Fed's rate suppression in spite of ongoing margin pressure. According to the FDIC, the quarterly average net charge-off rate for non-farm residential properties was 0.26% in the second quarter, while the trailing four-quarter-loss rate of 0.43% approximated the average annual loss since 1990.

As an example, Morningstar published an update Sept. 18 for a commercial mortgage that was originated by JPMorgan in 2007 and placed in a CMBS issue the same year (JPC07C20). The mortgage was made for a 657,000-square-foot office tower in a suburban area of a Southeast market that has an economic outlook of "stable" for 2013 and "up" for 2014. I think the office tower would be classified as "B+" by real estate investors. Mortgages originated during 2005-2007 were imbued with an increasing level of optimism or a blind eye necessary to keep originations, earnings and compensation flowing.

2007 optimism: Declining value for performing $60M suburban office tower mortgage

	Revenue ($000)	Net op. income ($000)	Net op. cash flow ($000)	Tower occupancy (%)	Cap. rate @ 12.0% ($000)	Cap. rate @ 10.0% ($000)	Cap. rate @ 8.3% ($000)
2007 Appraisal	-	-	6,682	-	-	-	80,500
08/14/07	10,143	5,904	5,496	85.00	45,800	54,960	66,217
12/31/11	9,081	4,932	4,524	73.00	37,700	45,240	54,506
12/31/12	8,648	4,957	4,549	66.00	37,908	45,490	54,807
06/30/13	8,316	4,700	4,292	68.00	35,767	42,920	51,711
2013 v. August '07 (%)	**-18.01**	**-20.39**	**-21.91**	**-20.00**	**-21.91**	**-21.91**	**-21.91**
2013 v. 2007 appraisal (%)	-	-	-	-	**-55.57**	**-46.68**	**-35.76**

2007 appraisal cash flow implied from stated 8.3% cap rate cited.
As of Sept. 18, 2013
Source: Morningstar Inc.

The mortgage on the suburban tower was for $60.8 million, while its 2007 appraised value was $80.5 million. Terms included a 6.22% coupon, interest-only payments for six years and 10-year balloon maturity in September 2017. The mortgage was underwritten assuming 85% occupancy and $5.5 million of net cash flow. The building was appraised for $80.5 million, implying there was 25% equity. Today the building is 66% leased following the loss of a large tenant in 2012, while the three largest tenants representing 24% of the square footage will see their leases expire before the loan matures in 2017.

Morningstar assigned a value of $45.4 million ($69 per square foot) in its September write-up based upon 2012 net cash flow and a 10% cap rate (versus 8.3% when the mortgage was originated in 2007). An adjacent tower sold in September 2012 for $41 per square foot, but Morningstar opined that the implied value of $27 million for the subject building based upon the comp seemed low. The assigned value represents a 44% reduction from the original $80.5 million appraisal and 111% of the current (and original) $60.5 million mortgage balance.

Value — at least the appraised value — has fallen sharply on a levered asset; however, investors in this particular CMBS deal do not face a disaster. The mortgage continues to perform, and it represents less than 3% of the CMBS pool. When the mortgage was underwritten in August 2007, the 8.3% cap rate represented a premium of 3.6% to the 10-year U.S. Treasury yield of 4.7% that prevailed during August per the Fed's H.15; today, the 10.0% cap rate represents a premium of 7.4% with the 10-year U.S. Treasury yielding about 2.60%.

The mortgage apparently is headed for a special servicer. Morningstar has taken a conservative tact by increasing the cap rate rather than holding it steady or reducing it even though long-term rates have fallen sharply since mid-2007. It remains to be seen what actions a special servicer might take and/or what may happen in 2017 when the mortgage matures. There was a lot of can kicking during 2008-2011 when lenders faced a wave of maturing loans that were underwritten during the easy-money days of 2005-2007. Maybe some cans continue to be kicked.

So, am I saying the CRE market is overheating again as banks prepare to release third-quarter earnings? No — banks will report great earnings from their CRE business units because funding costs are negligible, credit losses are fading, and loan yields comfortably exceed C&I loan yields. While this particular mortgage is not representative of office-related mortgages given the severity of the reduction in the property's cash flows, it illustrates the importance of the low rate environment that the Fed has engineered. Lower rates create valuation maneuvering room for lenders and investors; maybe values are overheating then, engineered indirectly by the Fed.

It also points to the reason that I think the Fed cannot allow long rates to climb much to the extent the Fed can control the long end — the economy cannot withstand a material drop in asset values. To the extent the Fed is "boxed in" by years of its zero rate policy, I think it implies that commercial real estate and other businesses that are dependent upon asset leverage will be pretty good until the rate environment really changes.

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