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# Getting the Facts Straight

Understanding industry dynamics is essential to navigating volatility

**COMMERCIAL MORTGAGE BROKERS HAVE** to deal with mixed signals in today's marketplace. Despite apparent recovery in the nation's macroeconomic indicators, lending remains tight as banks cannot shake off the over-cautious approach adopted in the aftermath of the financial crisis.

There also are a myriad of interrelated market dynamics — from struggling financial institutions to global economic uncertainty — that have continued to curb lender appetite and further complicate a much-needed recovery in the commercial real estate market.

It is not all bad news, however. The commercial real estate industry has seen some positive indicators this past year. For example, the nation's total office absorption was 34.6 million square feet in 2011 — nearly three times the occupancy gained the year before, according to Jones Lang LaSalle. With large blocks of space taken off the market, a gradual recovery in commercial real estate's overall rents and vacancy rates seems to be in sight — even though construction starts and property development are at record lows.

Commercial mortgage brokers who are striving to navigate their way through the industry's ups and downs need to have a full understanding of the factors that control lending and other aspects of the industry. Here are a few points to keep in mind.

## Unhealthy banks

Financial institutions, including banks, are still struggling. The interbank interest rate (Libor) is one benchmark that can indicate the current lending uneasiness. The U.S. Libor rate was 1.05 percent this past March, up from 0.77 percent a year earlier and the highest level since July of 2009. Essentially,

banks aren't letting their guard down yet.

In addition, changing regulations are adding to the uncertainty in the market. Basel III and Dodd-Frank regulations are highly unpopular — yet of vital importance. The main point of concern, according to the business journal of McKinsey & Company, *McKinsey Quarterly*, is that the U.S. banking system will need substantial capital in retained earnings or new equity to meet the new capital-adequacy standards — assuming the current asset level and mix.

Banks may see their returns fall by two-thirds unless they take steps to limit the fallout from tougher regulation. In some businesses, a portion of the high regulatory costs may be passed successfully on to consumers, *McKinsey Quarterly* reports. By some accounts, banks may need \$500 billion in new equity to meet the requirements of Basel III and Dodd-Frank.

## CMBS

Commercial mortgage-backed securities (CMBS) aggregate issuance hit \$32.7 billion this past year, 7 percent short of analysts' expectations as a result of uncertainty in global markets, according to Standard & Poor's.

The volume, however, is an impressive comeback after only \$12 billion was issued in 2009 and 2010 combined. The commercial mortgage market clearly needs this sector to recover because it remains the fastest in terms of timing and offers loan-to-value ratios (LTVs) in the 70 percent to 75 percent range, unlike the life companies.

## Construction starts

Commercial building construction starts fell to historic lows in 2010. Office construction starts tallied 56 million square

feet in 2010 — the lowest level of activity since 1960, according to McGraw-Hill Construction.

Hopes for recovery were dashed this past year with construction starts plunging further. The value of construction in 2011 was \$787.4 billion, a 4 percent drop from the \$803.6 billion in 2010, according to U.S. Census statistics. The decline was primarily a result of tight credit and reduced public spending.

Starts are projected to remain flat this year as existing space is absorbed. This lack of new construction has worried tenants that they won't be able to locate the space they need, especially large contiguous blocks in Class-A central business districts (CBDs) and suburban buildings in prime locations.

## Cash-rich corporations

The nation's corporations are hoarding cash that is estimated at a cool \$2 trillion. Although the economic crisis is now behind us, cash-rich corporations are not putting their money back into the economy. This reluctance to spend excess cash translates into less investment in new plants and purchases of technologies.

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Corporations are using cash for stock buybacks — suggesting that they've run out of new ideas. Stock repurchase produces higher per-share earnings (virtually the same amount of net income divided by fewer shares). Unfortunately, buybacks have not fulfilled their purpose of rewarding investors over the past 10 years.

This lack of investment in research and innovation is setting us up for trouble down the road that can result in slow economic growth.

Conversely, corporations that are able to access cheap debt are a reason for optimism. Target Corp., for example, sold \$1 billion of its debt at 1.13 percent in three-year bonds to support an ambitious growth and store remodeling strategy.

Corporate dividends were about \$240.6 billion this past year — the largest since 2008, when firms had not yet been hit by the full brunt of the financial crisis and paid a record \$247.8 billion in dividends, according to Standard & Poor's. The rating agency

projects corporate dividends to hit a record of \$252 billion this year.

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With these points in mind, it is clear that the commercial mortgage market still has a long way to go to see stability — let alone a full-fledged recovery. That said, commercial mortgage brokers who understand the factors that control this industry are taking the first step on the path of success despite the market's ups and downs. ●