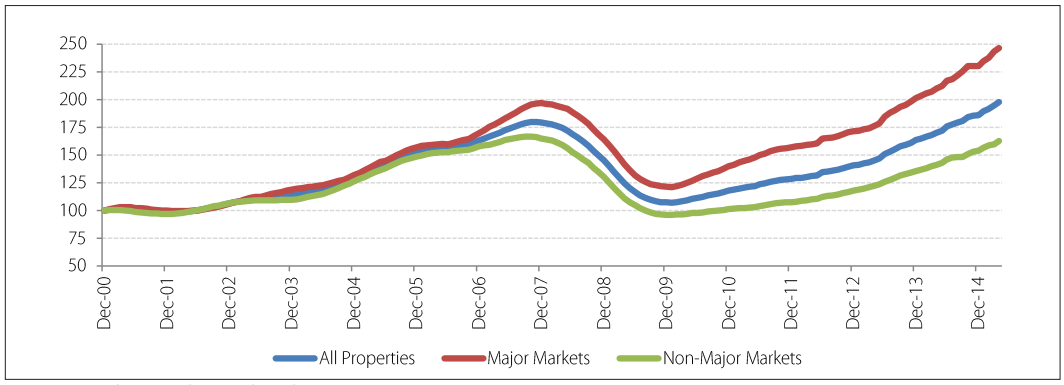
Is Commercial Real Estate in Another Bubble?

Commercial real estate prices are hitting record highs in primary markets and eager investors are moving in droves to secondary markets to snap up assets. Lenders of all sorts are looking to make deals, and the volume of mortgages outstanding has reached record highs in each of the last few quarters. In most markets and property types vacancies are dropping, rents are rising and absorption is improving.

Commercial Property Price Index (CPPI) January 2000 to April 2015



Source: Moody's & Real Capital Analytics

All the good news is similar to the lead-up to the last downturn, which gives rise to the question: are we in another bubble period for real estate like 2007?

My answer is possibly, but not likely. While nothing is certain, there are significant differences between today's market and the way things developed back then. During the last cycle, lending became increasingly aggressive, particularly among CMBS programs, which kept refinancing buildings with higher proceeds. Most of these deals were underwritten using "pro-forma" underwriting, which means the in-place cash flow wasn't enough to pay the mortgage debt service, but the assumption was that income would rise enough in future years to make the payments.

Of course, the economy tanked and many of those loans defaulted. Lending has increased over the past couple of years, but there are important differences, for example:

- Property fundamentals are moving in a positive rather than negative direction. In 2007, the economy was on the verge of an unexpected jolt in the form of the global financial crisis. Today, however, the job market is expected to stay strong for another couple of years.
- Vacancy rates and rents have been slow to improve in most commercial real estate segments and are likely to improve moderately for another 2-3 years. In 2007, rents had climbed sharply in recent years and were vulnerable to the recession and overdevelopment.
- Although there have been extreme swings, property prices on average have increased by about 3-4% over the last decade, not out of line with the returns of the S&P 500.

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- Few economists expect another recession for 3-5 years. Economic growth has been moderate since the recovery began, and signs in the job market point to improvements. For example, wage gains are starting to improve, the quit rate is growing (which means more workers are leaving for better jobs) and layoffs are relatively low. What's more, housing activity is on an upward trend and lower oil prices should give a boost to consumers.

- Like 2007, investors are paying inflated prices for assets. However, leverage is well below 2006-07 levels, when big deals were often financed with 90%-plus debt and multiple layers of mezzanine debt. Consequently, if prices drop, the risk is borne by the equity holders (in many cases foreign investors), rather than lenders, which cuts the systemic risk that led to the crisis in the last cycle.

- A related point is that the banking system has a lot less leverage. Banks in 2007 amassed huge portfolios of securities that they used for good things (such as supporting the CMBS market, in other words they would buy bonds that investors wanted to sell, which made for a highly liquid market) but also for ill (such as trading huge volumes of bonds for profit or engaging in derivatives contracts that couldn't be paid off when the market turned). Today banks have largely stopped buying and holding bonds on their books, so they aren't exposed to as much risk if the market turns.

- CMBS programs have less "aggregation" risk. In 2007, these lenders accumulated large pools of loans over the course of months that were placed in giant trusts that reached as high as $6 billion. Holding loans creates risk for the lender, because banks take a loss on the value of loans if prices decline during the holding period. Today, CMBS programs quickly sell loans they originate in smaller pools, usually about $1 billion. They have fewer loans on their books and hold loans for a shorter period to avoid risk.

Although these factors all point to a low probability of a crash in the next year or two, downturns usually come from unexpected sources. A sudden bad twist in the European banking saga or conflict in another part of the world could lead to problems in the U.S., so there is no reason to be complacent.

Still, the bottom line is that there is much less risk in the system for a variety of reasons, including the state of the economy, more conservative behavior on the part of market players and increased regulations that limit risk of financial institutions. From a fundamental point of view, absent an external shock, the real estate market should be in good shape for the near term.

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