

# Causes and Effects

## A Downturn May Be Looming for L.A.'s Commercial Real Estate Market

By JACOB YADEGAR

**W**ITH the collapse of the subprime mortgage market, lack of liquidity in the mortgage-backed securities market and lenders continuing to crack down on what they see as risky lending practices in commercial real estate, the pendulum has clearly swung to the conservative side.

Low interest rates and an abundance of money have led to great times for buyers and sellers of office buildings, hotels and other income-producing property. Buildings have traded at record prices and loan terms have become increasingly generous with many buyers putting little or no money into the deals.

### TWO VIEWS

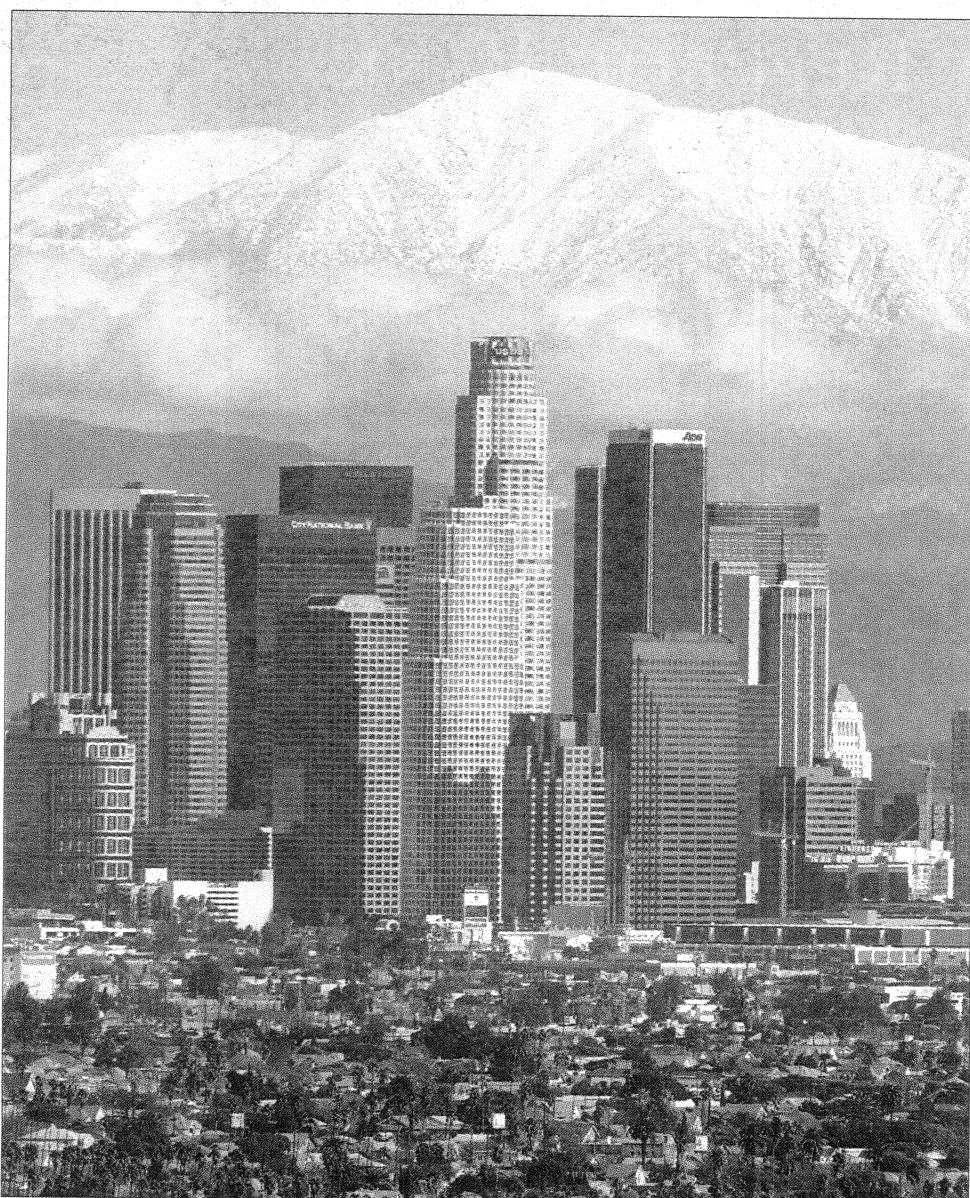
These two commentaries were written for the Business Journal on the outlook for L.A.'s residential and commercial real estate markets.

Like residential loans, commercial mortgages are pooled and packaged into bonds that are sliced into portions carrying different degrees of risk. According to rating agencies, there were nearly \$770 billion in commercial mortgage-backed securities at the end of last year, representing approximately 28 percent of all outstanding commercial mortgages with the remainder being held by banks or institutions on their balance sheets.

Unlike the residential real estate market, I don't expect as dramatic of a turnaround in commercial real estate values. Nevertheless, there is reason for concern.

As concerns are looming about the state of the economy, many reports are now suggesting that commercial rents will begin to drop as demand for commercial real estate diminishes because of problems in the housing market and the overall economy.

Neither the possibility of a slowdown nor the warnings about lax underwriting standards have led anyone to predict an imminent catastrophe in commercial real estate. The default rate for commercial mortgage-backed securities remains quite low and is not expected to increase appreciably in the near future. In fact, the delinquency rate for commercial mortgage bonds is still at the lowest levels since its delinquency index was created in 1999.



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**Next?: Lending practices may lead to a slowdown in L.A.'s commercial market.**

However, as was the case in the overheated residential mortgage market, many loans for commercial transactions have interest-only payments with very little reserves set aside by borrowers for reserves to cover taxes, insurance, improvements and other costs if things go wrong, and are based on projections for rent growth that is now clearly

too optimistic.

While many borrowers took advantage of the aggressive lending practices with short-term investment objectives, the more sophisticated long-term investors were much more conservative in the loans they took on. Those who took the more aggressive financing options will face severe problems if the econ-

omy continues to slow. They will not be able to refinance their mortgages because they borrowed more than what their property can currently service with today's more conservative lending guidelines.

In fact, many may be faced with foreclosure due to their inability to refinance since they can't generate sufficient income to service their existing loans and property expenses.

### Spreading crisis

Two years ago, I began advising clients that if things continued at an aggressive pace, the commercial mortgage market would suffer significantly as common-sense underwriting was ignored. Now we are seeing the liquidity crisis spread across all areas of the marketplace. There is still an abundance of liquidity in the market for commercial loans that are underwritten properly and make sense.

Overall, the economic signs clearly suggest a mild recession has already begun and I expect a minimum of 24 months before we see a recovery.

While lending practices have become more prudent, the availability of commercial financing is still available in the market through banks, insurance companies and institutional investors who are using a more conservative approach to lending.

Pricing adjustments will certainly continue to take place as the same property will now qualify for a smaller loan than just six months ago. Lower loan amounts will force buyers to make larger down payments. At the same time, we may see sellers reducing their prices.

The number of sellers will increase as many speculative buyers that purchased for a quick sale realize that they cannot continue to carry the property and the gains they were expecting would not be materializing for some time to come. Furthermore, as inventory of property for sale grows, sellers will begin to reduce their prices to entice buyers.

Prudent financing and planning are critical in protecting your assets to ensure long-term prosperity and just like the all you can eat buffet, self-control and discipline are tantamount to a good experience.

*Jacob Yadegar is chief executive of Empyrean Funding, a Los Angeles company that specializes in commercial real estate financing.*

## Local Residential Property Values Will Always Roar Back Stronger Than Ever

By MARK COHEN

**L**AST spring, I wrote an opinion piece for the Business Journal arguing that it remained a good time to buy real estate in the Los Angeles area. I also cautioned there would be an inevitable adjustment in the market. In the past six months, the market has changed dramatically. The credit market has tightened and home sales have slowed. Nevertheless, I submit that it remains an opportune time to buy real estate in Southern California. There's a very basic reason for my assertion: Every time the market has receded, it has always roared back stronger than ever.

Nationally, we've seen declining home prices for the past 18 months and more homes available for sale. When an individual area has a supply of existing homes on the market for six consecutive months, it is considered a buyers' market. Currently, there is over a 10-month supply of available homes in the U.S.

Moreover, markets differ dramatically region-to-region. Detroit and parts of Florida face a much more difficult challenge in

returning to a more normal market than Los Angeles. Building booms and weak economies impede recovery in those areas. However, here in Los Angeles, we have a significantly stronger economy, although one that has slowed over the past year.

Prices have come down in almost every region. But I would argue they adjusted to a more sustainable and realistic level. However, it is important to remember that home prices will not plateau forever, especially in Los Angeles. Indeed, we are already seeing signs that in more resilient areas prices have stabilized and will likely begin to increase in 2008 or 2009.

As in previous real estate corrections, some areas are more resilient to downward fluctuations than others. Neighborhoods in high demand and with limited areas in which to build have fared much better these past few months. These include many parts of the Los Angeles area - like the Westside and beach communities.

For example, a two-bedroom, two-bath home that likely would sell for \$600,000 to \$700,000 in less sought-after areas is still fetching over \$1 million in West Los Angeles.

Admittedly, a few years ago, that same house probably would have been listed at \$1.1 million, but there's little doubt it will command that price level again in the near future.

### Financing issue

Of course, regardless of the price-range of a home, most of us still need to finance the purchase. It's true, since this past August credit guidelines for lending have become extremely tight. The tight credit standards are a reaction to a period of too-loose standards in which many subprime loans were made to borrowers, who, frankly, should not have received the loans. This has caused lenders to be much more stringent regarding borrowers' qualifications across the lending spectrum.

Nevertheless, we must remember that credit remains available. And financing is already returning to more appropriate standards, thanks in part to the recent moves by the Federal Reserve Bank.

In today's market, lenders are looking for qualified buyers. Borrowers with credit scores over 700, who have verifiable income and

available assets for a down payment are getting their loans funded. We've also seen a much-needed improvement in so-called "jumbo" loans - those loans over \$417,000, which are common in L.A. and other metropolitan areas. Just a few weeks ago, the news stories made it seem as if these loans had all but disappeared or were priced unreasonably. But as some lenders have effectively removed themselves from this market, others have moved in, and "jumbo" loans are once again being funded and at competitive rates.

The most compelling argument for buying a home in L.A. during any type of market remains that homes here increase in value over time. Whereas no one can predict the future, history has proven time and again that in the long term, owning real estate in desirable areas of Los Angeles is one of the best investments you can make. The key is recognizing opportunity and striking when the iron is hot.

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