

## 2012 Mid-Year Update:

# Commercial Real Estate, Lending and Environmental Due Diligence

EBA Meeting  
Newport, RI  
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# Where We Left Off At EBA January

## 2012: Year of “Brake and Throttle”

- **Ingredients for a busy year.**
- **Market fragility will magnify setbacks.**
- **Stop and start activity likely.**



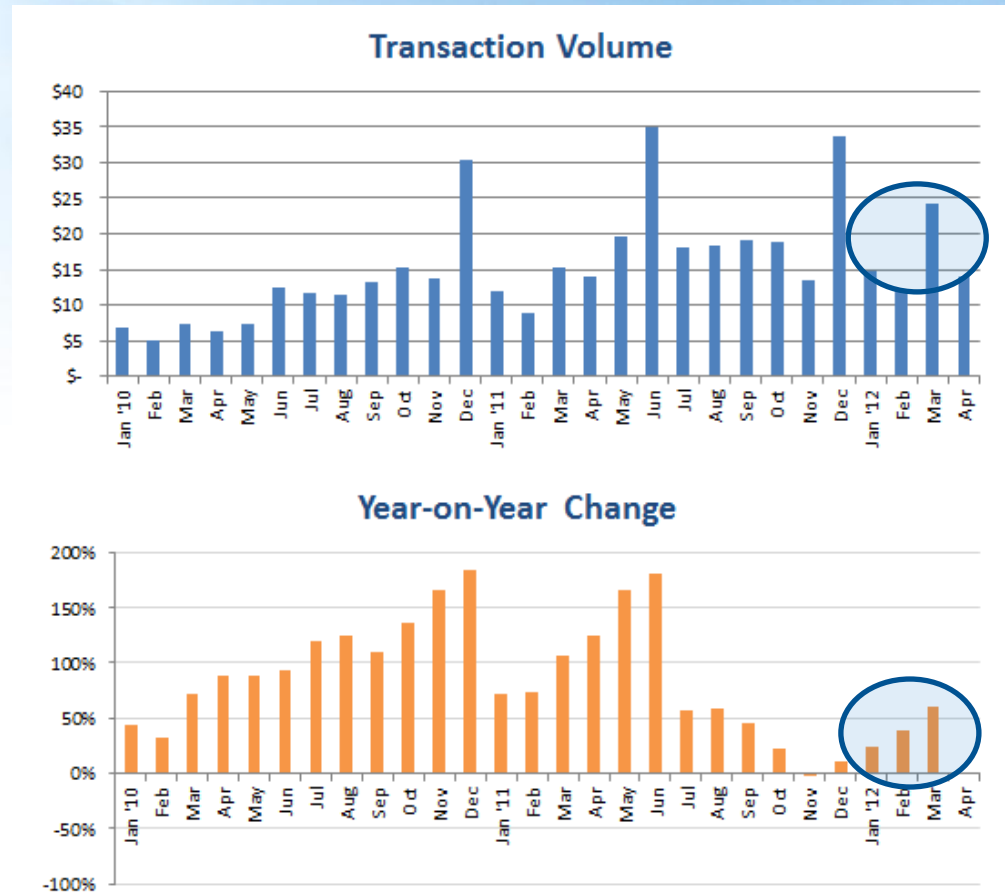
**Who's Buying?**  
**Who's Lending?**  
**What About Risk?**  
**What Next?**

# Who's Buying?



# Deals Up, But Momentum Has Slowed

- Transaction volume in 1Q12 was up 40% from a year ago:
  - Portfolio work drove much of the gain.
  - An 89% increase in retail property sales in 1Q12 compared to 1Q11.
- Momentum is slowing.



# Who's Buying?

REITs raised a record \$51 billion in 2011, the bulk of which is expected to flow into commercial real estate.



This infographic was created by Ashlev Gowen. EDR Insight (March 9, 2012)

- Approx. 150 private funds investing in U.S. real estate reported raising \$16.3 billion in the first quarter of this year.
- **More than double** the \$7.97 billion raised in the fourth quarter of last year.

# Word from Investors

- *“It would be crazy to close without a property condition assessment or environmental due diligence.”*
- *“We generally try to close deals within two weeks, depending on deal size.”*
- *“I’d advise anyone doing deals today to model the downside before moving forward.”*



Source: EDR Insight’s Strategic Brief on the Crittenden National Real Estate Conference, San Diego, CA.

# A Look at Assets Moving Into Play

- \$362 billion in maturing loans—on top of \$346B 2011 volume
- Properties with vacancy rate of 60% or more:
  - Retail: 67,525 properties
  - Office: 49,240 properties
  - Industrial: 42,475 properties
- Banks are now holding:
  - Over \$240B in troubled assets
  - \$27.9B in foreclosed commercial real estate
  - \$160B in troubled commercial mortgages to resolve or dispose
- CMBS loans in special servicing:
  - \$82.3B
  - Plus another \$140.8B in loans that CMBS loan servicers listed as having potential credit concerns.



# Property Type

- Multifamily: still hot
- Retail: recovering but bifurcated
- Hotels: accelerating



# Geographic Disparity Continues

## Top 10 Metros for Phase I ESA Volume (YTD '12 vs. YTD '11)\*



Source: EDR ScoreKeeper Model  
Map: [http://en.wikipedia.org/wiki/File:Blank\\_US\\_map\\_borders.svg](http://en.wikipedia.org/wiki/File:Blank_US_map_borders.svg)

\*Based on the 54 top commercial real estate metros in the U.S. sources, Inc.  
(MSA level data, current through 5/31).

# Who's Lending?



- **THEN:**

- Remember the days of higher LTVs or even 100% financing?
- Or underwriting assumptions that forecast rent bumps, sky-high occupancy rates and rising valuations?

- **NOW:**

- Credit conditions recovered first for top-quality borrowers, Class-A assets and in primary markets.
- Assets with any sort of risk profile and borrowers without a strong track record, however, remain more difficult to finance.

# Sources of Commercial Real Estate Debt

- CMBS (Securitization): Recovering
- Life Insurance Companies: Peaking
- Commercial Banks: Recovering
- Credit Unions: Emerging
- Government: Over-heated
- Private Equity: Active

Source: Tom Fink, Trepp LLC in comments at EDR's 2012 Client Summit.



# Disparity in Lending

- Still not a great deals of interest—or capital—yet available in secondary and tertiary metros for average-quality assets
- Tight lending in smaller towns and rural areas
- By bank size:
  - Large national banks focused on gateway markets and institutional properties.
  - Regional banks have slowly picked up their commercial lending.
  - Obstacles to lending remain for smaller banks struggling with distressed commercial real estate assets.

# Restructuring, Divesting

- Loan restructurings continue, past restructurings being revisited
- Discounted loan pools continue to be offered, abundantly (loan pools carefully chosen to mix stars with dogs and cats)
- Respondents currently liquidating commercial real estate loans and REO is still high:
  - Liquidating commercial real estate loans (47% of respondents)
  - Liquidating REO (76%)
- Early innings of this process.

Source: EDR Insight's 1Q12 Survey of Financial Institutions.

# Refis: Turning Over Stones

- Financial institutions are already conducting environmental due diligence in support of high volumes of refi requests.
- Common problems:
  - Can't find previous environmental reports
  - Poor report quality
  - New environmental issues stemming from property neglect
  - Findings/recommendations that do not reflect today's more stringent standards.

*“On loan maturities, we’re seeing issues from old reports that were not investigated and now require due diligence.”*

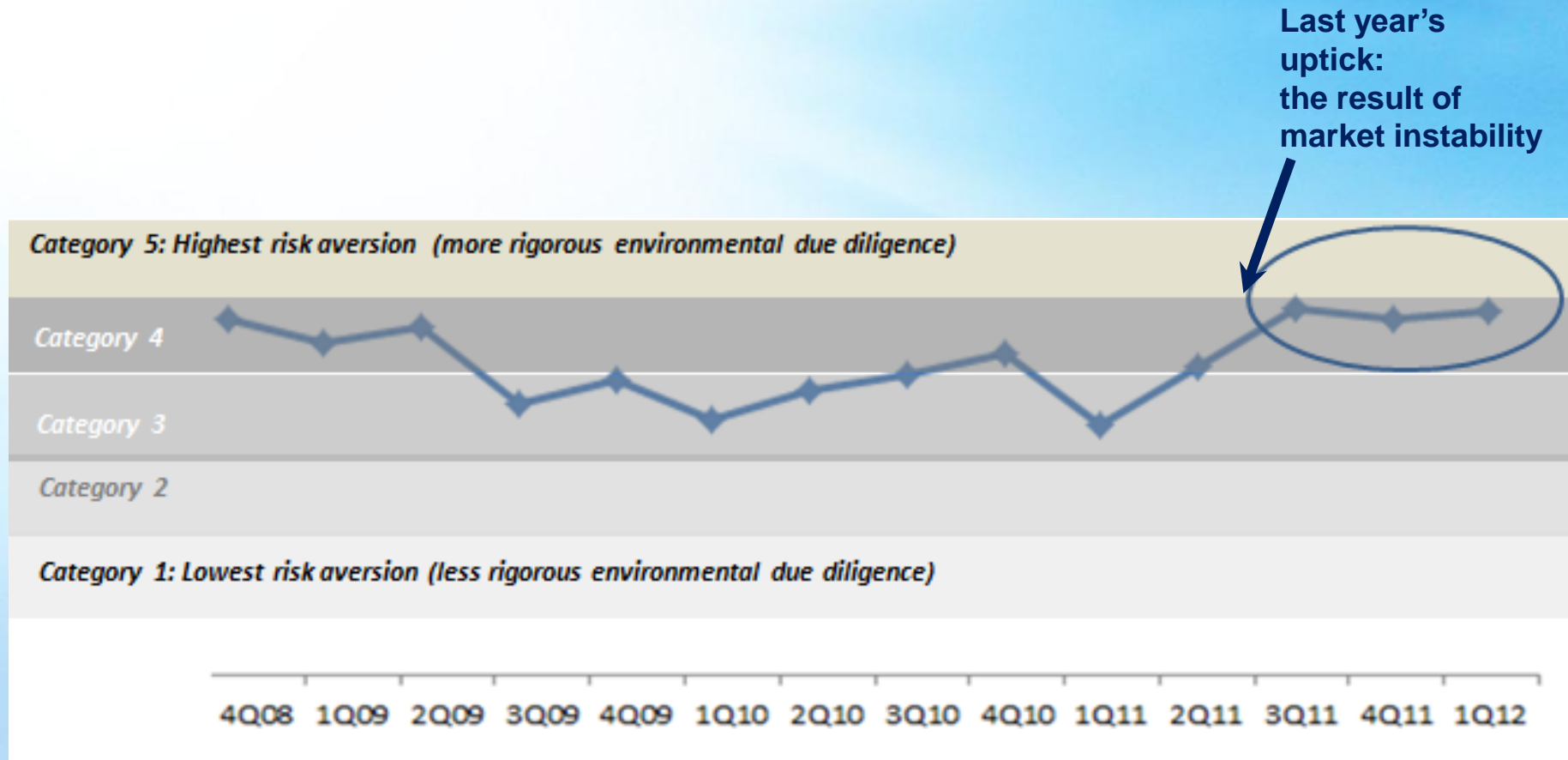
Source: EDR Insight’s 1Q12 Survey of Financial Institutions.



# What About Property Risk?



# Risk Aversion Index Remains Elevated



# Lenders and Environmental Risk Aversion

- A significant 80% had risk tolerance that remained at 4Q's high levels.
- Respondents with “more stringent” environmental due diligence standards in 2012 versus prior year more than doubled

25% vs. 12% in 4Q

- Increase in the percentage of Phase I ESAs proceeding to Phase II ESAs:

12% versus only 6% in 4Q survey

*“Our tolerance is the same. The shift has been in the properties we are seeing. We are seeing more high risk properties today.”*

# U.S. Property Assessment Market

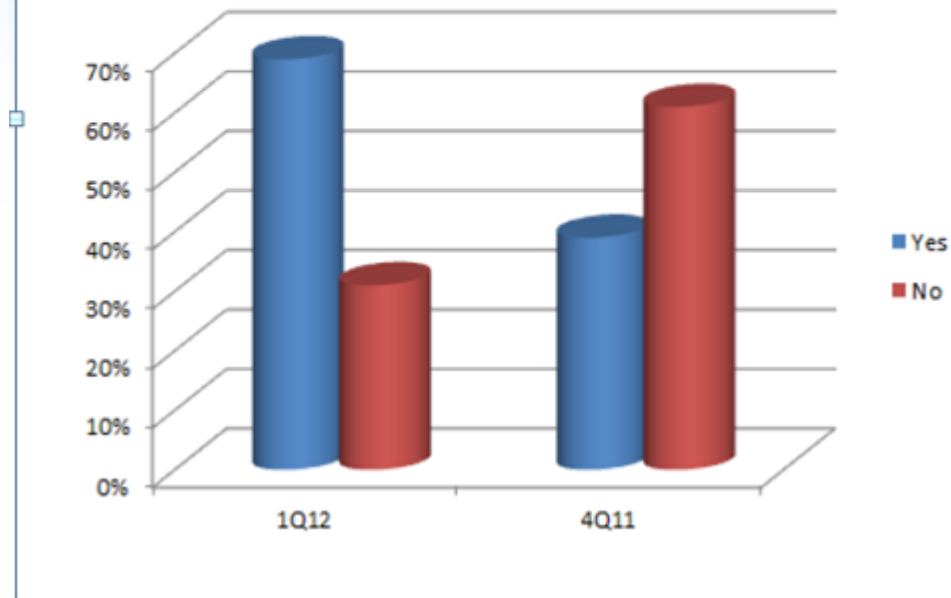
- Across all ten property assessment types, there were approximately **404,500 assessments** conducted in the U.S. in 1Q12, including:
  - 52,997 Phase I ESAs
  - 12,423 Phase II ESAs
  - 37,269 Property Condition Assessments and
  - 98,348 Appraisals
- \$668.2 million market size

Source: EDR Insight's Property Assessment Market Model, 1Q12 Quarterly Update

**Do your environmental consultants typically charge the bank a premium if a faster Phase I ESA turnaround time is required?**

\*A significant 69% of respondents have environmental consultants who charge a premium for faster TAT compared to only 39% in 4Q11.

\*This finding emphasizes the importance of efficiency and speed in due diligence, a point supported by a number of panelists at EDR's recent client summit.



- Speed, efficiency are critical, especially on portfolios

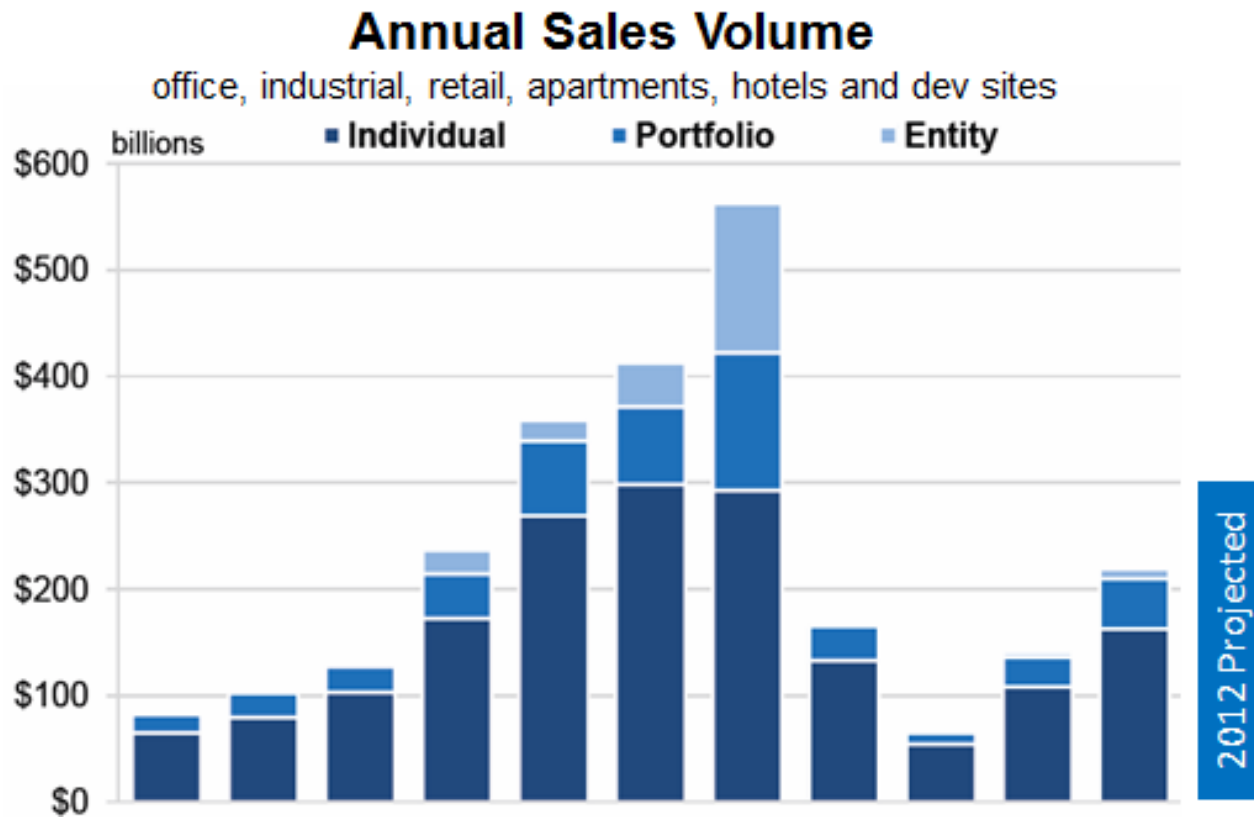
# Education Will Be Key As Market Recovers

- New lending, investments are on the board for 2012.
- Banks, investment firms are replacing past layoffs with junior staff.
- Leading to a “rustiness” in engaging Phase I ESAs.
- A learning curve as market adjusts to new risk aversion.

# What Next?



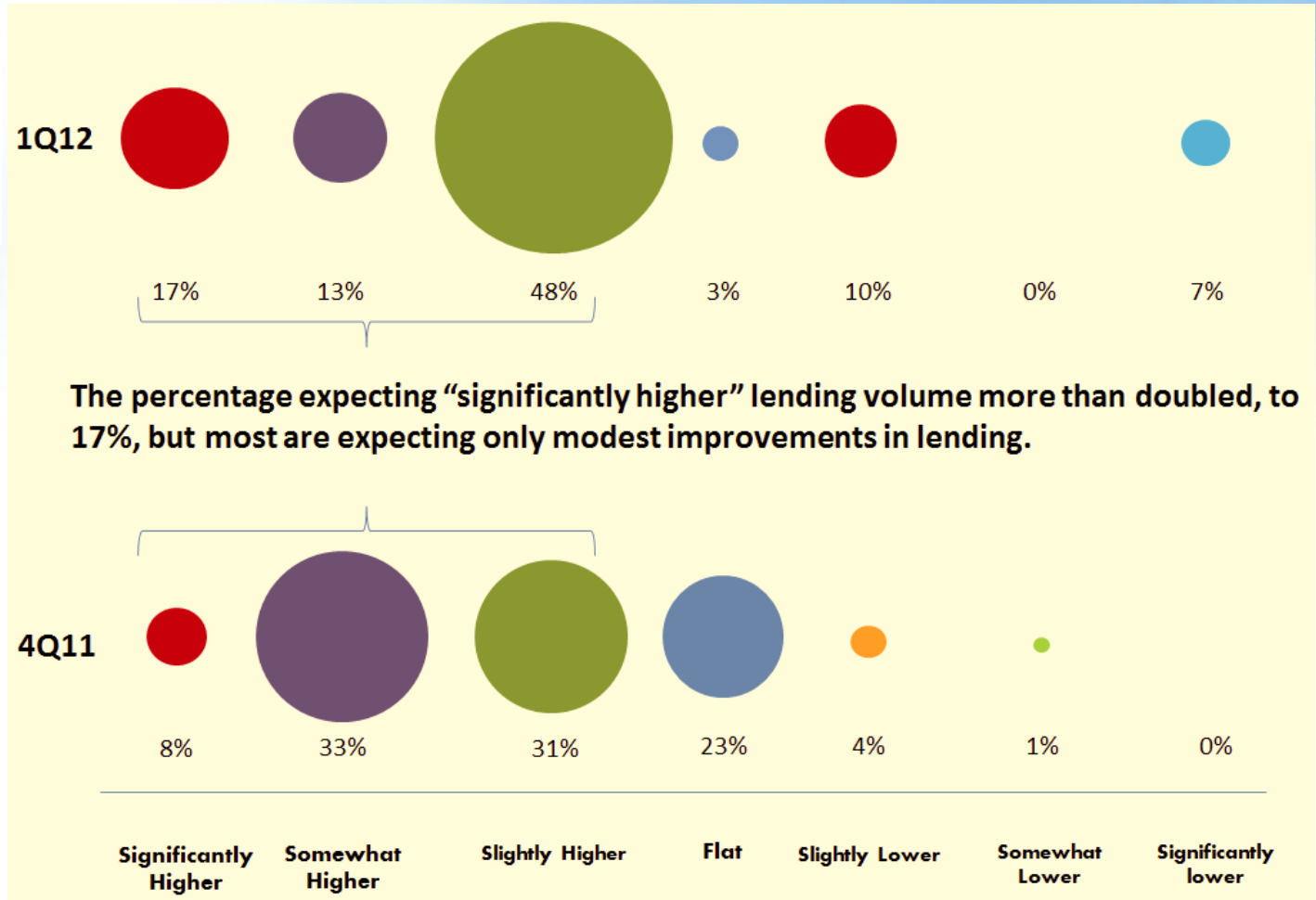
# Forecast for Commercial Real Estate Deals





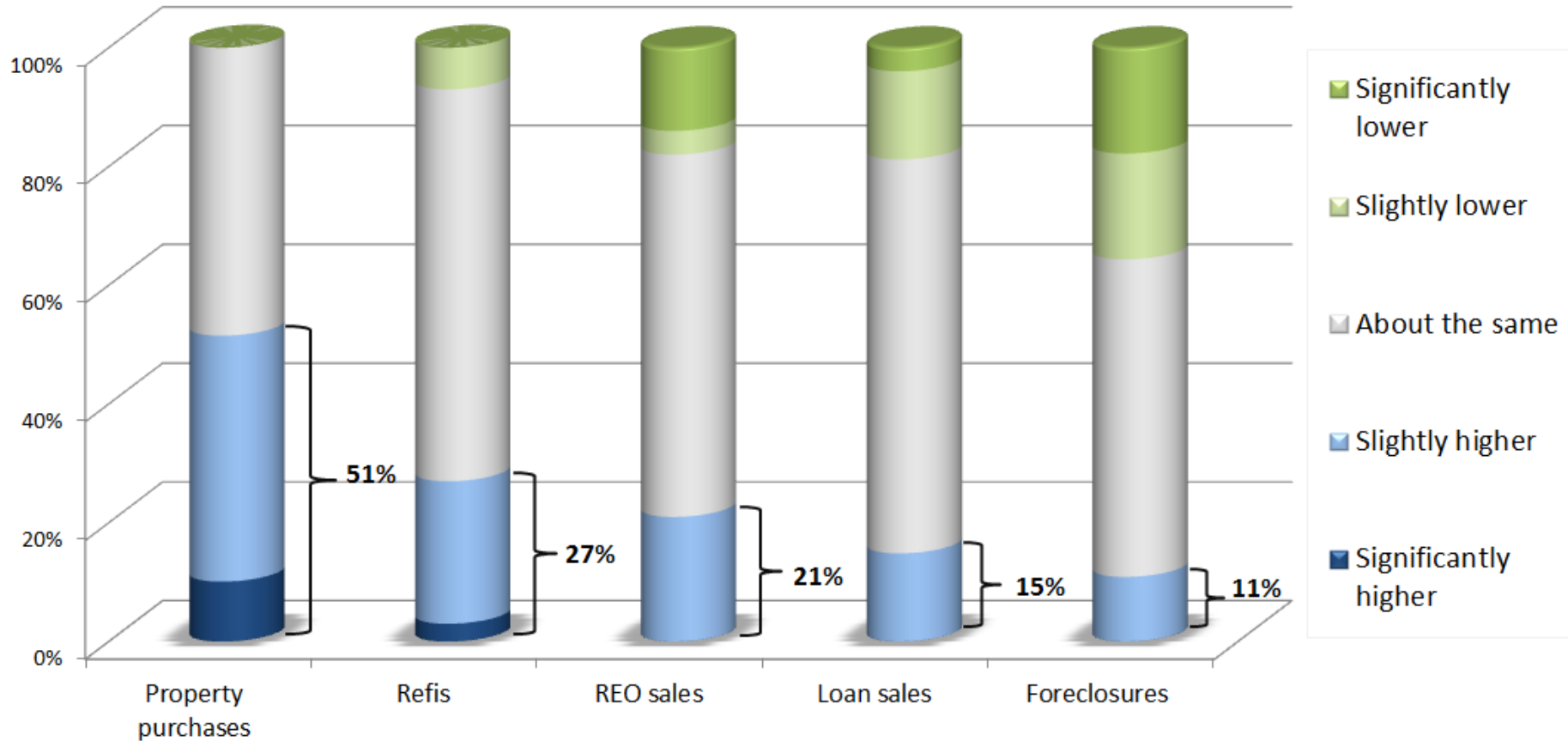
# Forecast for Originations

Looking ahead to 2012, what are your expectations for commercial real estate lending volume relative to 2011?



## How do you expect the volume of your institution's EDD in each of the following areas in 2012 compare to 2011 levels?

\*Only 11% of respondents expect more foreclosures in 2012, while expectations are higher for property purchases, refis and REO sales.



1. Mid-year 2012 activity is up over 2011 levels, but still uneven, unpredictable
2. Firms are starting to staff back up (EPs and end users)
3. Moderate increase in bank lending
4. Big driver is multifamily, the star performer
5. Risk aversion elevated, aftershock of '11 roller coaster ride

*“There are no dumb investors out there.”*



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