Commercial break

Disaster looms in yet another asset class

General Growth Properties (GGP) and the Great Basin Bank do not have a lot in common. One is America's second-largest mall owner, the other a small bank in Elko, Nevada. But both shut their doors within a day of each other this month because of their exposure to commercial property, the most threatening in a line-up of suspect asset classes.

Vegas fashion victim
Alamy

GGP filed for Chapter 11 bankruptcy protection on April 16th. Its assets, which include the Fashion Show Mall in Las Vegas (pictured) and South Street Seaport in New York, are high-quality and continue to generate decent income. Its financing structure is what got it into trouble. GGP found that it simply could not roll over its debts because of a lack of liquidity.

GGP's difficulties were not unexpected. It was carrying lots of debt, principally because of a big acquisition in 2004, and much of it was short-term. But its failure still sends two shock waves. First, by including several properties that back commercial mortgage-backed securities (CMBS) in its Chapter 11 filing, GGP has unnerved investors who expect such assets to be ringfenced in a bankruptcy.

The second shock wave is that GGP's bankruptcy underlines a pervasive refinancing risk for the industry. Foresight Analytics, a research firm, reckons that $594 billion of commercial mortgages will mature in America alone between 2009 and 2011. Many of these borrowers will have a big problem when their loans mature. Just as in residential property, the financing terms that were available to property and construction firms got ever laxer as the bubble inflated. Loan-to-value ratios of 85-95% were common in 2006 and 2007. These have now tightened to 60-65% and below for new lending.

That would be bad enough if prices were static. They are not. Commercial-property prices have fallen by 35% or so in America. Richard Parkus, of Deutsche Bank, thinks that 70% of all CMBS issued recently in America will not be able to refinance without a big increase in the capital that borrowers stump up.

It is likely to be a similar story with bank lending. Many banks are extending loan terms, hoping that the problem will go away. It will not. A growing overhang of debt will only make it harder for the market to recover. And the full effects of the bust are only just beginning to be felt. Losses on commercial property tend to lag behind rises in the unemployment rate by a year or so, largely because lease terms protect landlords from immediate falls in rental income. (An exception is the hotel industry, where leases are, in effect, renewed daily). The pain is now arriving. Office vacancies in America's city centres increased to 12.5% in the first quarter, up from 9.9% a year earlier. Delinquencies are spiralling. Write-offs on bank-held commercial-property loans rose sevenfold in 2008.

The potential for further damage to the banks is especially worrying. Morgan Stanley's first-quarter results on April 22nd included a $1 billion loss on its real-estate investments. But the loan books are where the real concerns lie. Commercial-property loans, including construction and development, account for 22% of American bank loans, up from an average of 14% in the 1980s and 1990s.

Smaller banks are exposed. Matthew Anderson of Foresight Analytics says that banks with assets between $100m and $10 billion hold commercial-property loans worth more than three times their total risk-based capital. Great Basin Bank, the 25th American bank to fail this year, was undone by heavy losses on commercial property. It will not be the last.

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