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COMMERCIAL REAL ESTATE

PROPERTY REPORT

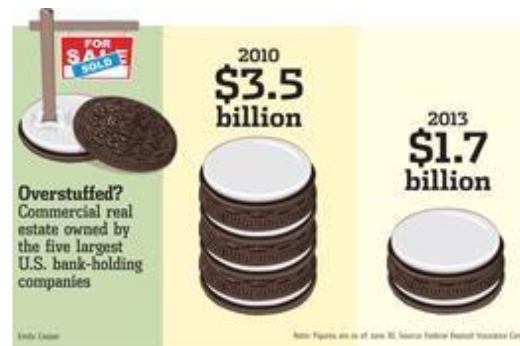
Bad-Loan Revival Unburdens Banks

Rising Values Let Lenders Shed Foreclosed-Property Portfolios

By ELIOT BROWN

Western Alliance Bancorp. got a pleasant surprise in May when it sold a vacant store in Victorville, Calif. out of its foreclosed-property portfolio.

The Phoenix-based bank had internally marked down the value of the 30,000-square-foot property, which fell into default in June 2012, to $972,000 from the $1.2 million value of the loan. Western Alliance was actually able to book a profit by selling it for $1.1 million to David Hong, who plans to use it to house his clothing-embroidery company.

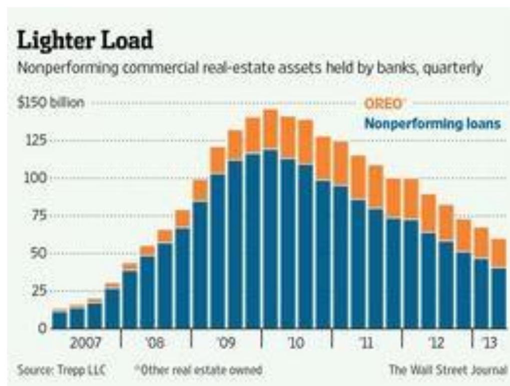


"As real estate values have risen, along with demand from buyers, banks are in the better position to dispose of their OREO," Robert Sarver, Western Alliance's chief executive, said in an interview, referring to Other Real Estate Owned, the term the banking industry uses for foreclosed properties.
Rising commercial property values throughout the country have enabled banks to cleanse themselves of the mountains of distressed office buildings, shopping centers, hotels and other real estate that they reluctantly took over during the financial downturn. That has helped banks return to health and transferred thousands of properties to new investors who have breathed new life into them.

What is even more important is what didn't happen. As delinquent loans and OREO swelled, there was widespread fear among regulators that commercial real estate would follow residential real estate off the cliff and deliver another massive blow to the economy. In 2010, bad commercial-real-estate assets hit a postcrisis peak of $146 billion, according to debt research firm Trepp LLC.

Banks posted huge losses and dozens failed due to bad commercial real-estate loans made during the boom years. But the pain wasn't nearly as bad as expected, in large part because banks didn't sell their troubled loans and foreclosed properties during the darkest days of the downturn and values bounced back faster than many expected, banking and real-estate experts say.

Banks have whittled down the volume of bad loans and OREO to $60 billion by selling assets or working out deals with borrowers, according to Trepp. For commercial OREO alone, the five largest U.S. banks have reduced their holdings to $1.7 billion in the second quarter, down from $3.5 billion in mid-2010, according to the Federal Deposit Insurance Corp. "I sleep a lot easier today," says Julie Stackhouse, a vice president at the Federal Reserve Bank of St. Louis, which has examined the holdings of banks' foreclosed properties.



Meanwhile, in the real-estate industry, the steady sale by banks of the troubled assets has boosted a new class of developers and investors. While moguls and institutions have been on the other side of most high-profile distressed sales of assets such as Worldwide Plaza in Manhattan, the great majority of properties sold have been purchased by mom-andpop investors, immigrants and other smaller players, property brokers say.

Mr. Hong, who bought the store in the Victorville strip shopping center, is the 36-year old son of South Korean immigrants. His manufacturing company, X-Treme Stitching, which specializes in baseball hats, will take half the space and the other half will be sublet to retailers, he says.

Banks are the largest holders of commercial real-estate debt, with about $1.1 trillion of the total $2.1 trillion in commercial mortgages, according to the Federal Reserve. Many decided in the early years of the crisis not to sell OREO and distressed loans because they wanted to avoid a repeat of the early 1990s, when lenders dumped assets at huge discounts only to see them rebound in value in a few years.

Their strategy this time to hold and extend troubled loans rather than sell was derided by critics as "extend and pretend." But now many who raised red flags at the time say the practice looks smart in hindsight.

"It's worked a lot better than I would have guessed," said Arthur Segel, a real-estate professor at Harvard Business School.

U.S. banks wrote down the value of their commercial real-estate holdings by $134.5 billion between 2007 and 2012, according to the Mortgage Bankers Association. But banks are getting better prices as the real-estate market has improved. For example, in 2009, lenders were taking 70% to 80% losses when selling risky assets like raw land, according to Matthew Anderson, a managing director at Trepp. Today that discount is in the 30% to 40% range, he says.

Bank selling also has picked up in the past few years as values have rebounded. U.S. commercial-property values have increased 42% since hitting their postcrash trough in 2009, according to the Moody's/REAL Commercial Property Price Indices.

Of course, for commercial loans, the problem hasn't gone away. The cache of OREO and delinquent loans is still far larger than historic levels—it was $13.6 billion in the first quarter of 2007 for U.S. banks, according to Trepp.

Many community banks in particular continue to struggle, and banks with less than $1 billion in assets have cut their OREO and delinquent loans by only 40% since 2010, according to Trepp.

The steady sale of OREO and troubled loans has helped fuel a virtuous cycle within the commercial-property markets. New owners are reinvesting in buildings, helping boost the value of surrounding properties.

A set of 16 condominium town houses in La Mesa, Calif., sat vacant for more than four years, after Bank of America Corp. foreclosed on the nearly-completed project in 2008.

In May, investment group Pathfinder Partners LLC bought the property for $3.1 million. After the floors were fixed and lighting fixtures replaced, the town homes are being rented now. Pathfinder co-founder Lorne Polger says he is on track to eventually sell the units for two-thirds more than he paid for them.