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Property defaults looming concern

*17 comments*by ***J. Craig Anderson*** *- Feb. 8, 2009 12:00 AM*
The Arizona Republic

The foreclosure wave that gathered momentum in the housing market last year is careening toward apartment, storefront, office and warehouse properties, with billions of dollars in commercial mortgage loans in danger of default.

About $4.5 billion in securitized commercial mortgages is set to mature in the Phoenix area this year, with little hope of refinancing for commercial-property owners whose equity has slipped away.

Many small-business owners will struggle to make their loan or lease payments in 2009, experts say. Storefronts will be boarded up. Office and industrial buildings will empty out.

"The commercial market really hasn't taken its hit - yet," said Beth Jo Zeitzer, president of R.O.I. Properties in Phoenix. "We'll see a similar pattern to what's happening in residential real estate."

Atop the list of brokers' concerns is the dramatic rise in securitized commercial mortgage loans placed in "special servicing" as 2008 drew to a close, which usually means the borrowers fell behind on their loan payments or failed to pay off a matured loan.

According to commercial real-estate analysis firm CoStar Realty Information, based in Bethesda, Md., the value of monthly payments for securitized commercial loans in special servicing nationwide quadrupled from $400 million to $1.6 billion between September and November.

Nationally, the aggregate outstanding balance for securitized commercial mortgages, those sold on the secondary market as investments, totaled about $850 billion at the end of 2008.

In Arizona, only 39 securitized commercial mortgages were in default at the end of the year, CoStar's data shows.

However, there are an additional 212 Arizona loans on the firm's "watch list" of loans likely to enter into default in the coming year because of "potential credit issues."

Loans for constructing new commercial buildings usually are structured in such a manner that they must be paid off in just a f ew years, said Jerry Noble, a commercial broker with CB Richard Ellis in Phoenix.

They are essentially bridge loans that require a sizable balloon payment at maturity, he said. Most commercial property owners refinance that debt before the final payment is due.

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"Right now, you can't go refinance," Noble said. "We are starting to see major office complexes go into foreclosure."

So far, Phoenix-area apartment buildings and unsold lots inside subdivisions have suffered the biggest increase in commercial mortgage loan delinquencies, which Zeitzer said was consistent with a standard recessionary pattern that begins with housing and then shifts to retail, followed by office, and then industrial.

In many cases, the buildings and land already have reverted back to lenders, she said.

If done properly, tenants in repossessed apartment buildings are able to keep living there with a court- or bank-appointed receiver managing the property.

Residents inside half-built subdivisions don't generally enjoy such a seamless transition to bank ownership, Zeitzer said, as their communities often face financial hardship and declining conditions in common areas.

Retail is usually the next commercial sector to suffer during a housing-market downturn, according to CB Richard Ellis.

The brokerage's most recent report covering the Phoenix-area retail sector in the fourth quarter shows a steady increase in the vacancy rate since 2006, reaching 7.5 percent at the end of 2008.

Meanwhile, one major retailer after another announced store closings during the fourth quarter, including Circuit City, Linens 'n Things, Mervyns and Kmart.

There were 6.8 million square feet of empty big-box space in the Phoenix area at the end of 2008, up from 3.9 million square feet a year earlier.

The office market is experiencing a similar trend, Noble said.

"Vacancy is literally going up fractions of a percent every month, and it's going to continue," he said.

The reported average office vacancy rate in Phoenix was about 19 percent in January, but Zeitzer said that number doesn't take into account tenants that are still under lease agreements but have vacated because of office consolidation or business failure.

A vacancy rate in the high 20s is more realistic, she said.

"It's not pretty," she added. "Our office building is probably 35 to 40 percent vacant."

Regionally, west Phoenix had the highest office-vacancy rate - about 38 percent - in the fourth quarter, according to CB Richard E llis, while central Phoenix had the area's

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lowest vacancy rate: less than 13 percent.

Problems with industrial properties, which include construction-related businesses and warehouse space, usually lag behind office and retail, Noble said.

However, the Phoenix area saw a sharp increase in vacant industrial properties in the fourth quarter, up more than 4 percentage points from a year earlier to reach 12.5 percent.

"That's actually hitting pretty fast and furious," Zeitzer said.

In all commercial sectors, many property owners and tenants have had difficulty paying their monthly bills, the brokers said.

On the positive side, a number of landlords and lenders have been willing to modify lease and loan agreements to prevent tenant eviction or bank foreclosure.

Still, 2009 is expected to be a treacherous one for many businesses, with retail sales, property values, employment and other economic indicators continuing to decline.

"I think it's going to be difficult for a lot of mom-and-pops, the local businesses, to hang on," Zeitzer said.

Reach the reporter at 602- 444-8681 or craig.anderson@arizonarepublic.com.

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