

The commercial real estate advisory firm of Galling Glick Sullivan & O'Keefe, was invited to speak at the Williams Club this past spring. Frank Sullivan of said firm spoke at the luncheon and this was his introduction.

For further information about the firm and it's partners, please visit <http://www.gallinglick.com/>.

## **It's the Assets, Stupid**

At the time of the S&L crisis of the late 1980s-early 1990s, thrift lenders were falling into the RTC black hole at a cascading rate. They were gone and not coming back. The cause of their demise was commercial real estate loan defaults and foreclosures. These banks had been very aggressive in financing a building boom that led to a vast oversupply of vacant buildings across the United States. Absorption of office space was estimated in some cases, like downtown Chicago, to take almost two decades. The results included a freeze-up of lending for real estate.

Developers and investors were perplexed as to what phenomenon might possibly occur to replace these banks as sources for financing. Life companies could not fill the void, commercial banks were out of the picture for the most part and the thrift industry was a shadow of its former presence.

Enter Wall Street and its ingenious creation of the CMBS market. Financial engineers sliced diced, structured and brewed financial concoctions that were billed to be safe, sound and secure. After all, they reasoned, you mix up a lot of cats and dogs and even if a small percentage of them get sick, the vast majority of them will be fine and healthy enough to more than cover the loss. Unfortunately, this financial model seems to have failed to take into account cycles and the fact that a sinking tide lowers all yachts.

Now, of course, we find ourselves mired in slag heaps of complex financial instruments with no clear way out. The financial engineers who created this are eager to try to unravel the mess provided they are well compensated for their genius.

I, for one, think they should apply their skills to more abstract endeavors, like math or rocket science. That's because what counts here are the assets that back all this paper. The paper is paper. The assets are hard, real buildings. These buildings are operating properties. They must be leased, managed, operated and maintained. They are dynamic assets, not static or passive documents. If you own them, you are responsible for the life, safety and care of its occupants and users. The buildings tenants are businesses, companies and residents who have ever changing needs. As physical assets, buildings require care, maintenance and improvement to maintain viability.

If you walk through a building with a professional real estate owner or manager, it's a very different experience than touring with an investment banker. Real estate professionals see things like ceiling heights, column spacing, layouts, and mechanical systems. Take a loan underwriter into a boiler room and he (or she) will observe if it looks clean and well maintained. Take a building operator in and he (or

she) sees what are the capacity, efficiency and condition of the mechanical systems to heat, cool, light, and to operate elevators, escalators and other moving parts of the asset. Tour an office building with a leasing agent and you will know what building features appeal to tenants and what obstacles there are to overcome relative to the building's competitive set. Or walk through a regional mall with a mall manager and be told things like "we have seven women's shoe stores in this mall and the store you looking at ranks last in per square foot sales. The store manager hasn't changed the window in over three weeks. Our women's shoe sales are below regional and national averages. We know we can do more sales in this category, so we're not going to renew this lease when it's up and if we can get them out sooner, we will." CMBS loan originators looked to confirm that the tenants in occupancy match the rent roll. They reviewed historical and current financial statements and analyze how much income is available to pay debt service. They discovered that if you use interest-only loans you could lend even more. Of course, they became so competitive and overly-aggressive that they factored in rent increases on rollovers to justify higher cash flows and therefore larger loans. They covered projected shortfalls in debt service by creating reserves estimated to be sufficient to pay these deficits until the assumptions of ever increasing rental income became reality.

We're not going to financially engineer ourselves out of this mess. The smart ones are those who will get control of the asset or cause those in control to hire a team that can stop the bleeding, reassure the tenants, improve the income stream and take steps to preserve the asset in a way that protects and enhances its value.