# PROPERTY VALUE DETERIORATION

by Steve Brown

In an attempt to better understand how commercial property prices deteriorate, we looked at appraised values for a group of 3k commercial real estate loans with in-place cash flows (non-land) that were originated prior to the downturn in September of 2007 and had at least 1 new appraisal done after Sept. 2007. The idea was to see what can be learned by property value changes over time and its impact on capital. Of course, this is a negatively selected group of loans, as appraisals are largely ordered on riskier loans or loans with problems, so we don't want to give bankers the notion that this is what is happening with all properties. Of the loans we looked at, about 55% had 1 post-crisis origination appraisal; while 32% had 2 and 15% had 3 or more. This analysis has given us an unprecedented view of property value performance that will allow us to not only manage the next downturn better, but also the tail end of this one. The first take away is that the net change of appraised values outside of normal real estate value volatility came in month 16 (around the end of 2008). At this point, property values passed 2 standard deviations, thus confirming the fact this was not the average business cycle at work. That this may seem obvious in retrospect, but a large number of banks started to recognize problems, but instead of sounding the alarm bells, they continued to originate similar loans despite the fact there was a known credit shock to the portfolio. By month 23, commercial real estate suffered its greatest decrease in value to the order of 20% to 40% of original value. In addition, we point out that most lenders did not conduct re-appraisals until mid-2009, with many holding off until early 2010, thus contributing to a lack of transparency. After month 23, values continued to slide and it wasn't until 3Q of 2011 did we see our first material stabilization of value, a full 48 months after the downturn. Now this is longer than downturns in the past but the rate of deterioration and stabilization is consistent with both the 80's and early 90's. We point out that we have yet to hit the bottom, as the next major demarcation in this analysis will be when 51% of these loans show an increase in value that isn't projected to occur until around 4Q of 2012. This will be the nadir of property values and will give us a better feel how time impacts property performance and therefore, bank capital. If today was the bottom of the commercial real estate property market, the average CRE bank collateral would be down 52% in value from the time of origination. We suspect that this number will be closer to 58% when the nadir does roll around, giving us a new low in which to stress test bank portfolios and to adjust our credit default model. Other takeaways include the fact that credit deterioration follows a normal distribution, but one with a positive skew meaning that a larger number of loans suffered a less than 52% decrease in value than suffered more than a 52% decrease in value. In other words, for a practical application, if your loan suffers a larger than average drop during the first appraisal, chances are more losses are to come on that loan that with a new loan. Finally, it is worth understanding the importance of vintage segmentation, as the decreases in property values were largely symmetrical to the price increases of value for those years. For example, early 2007 was the pinnacle of property value and loans originated in this time period suffered the largest write downs. 2006 was next, followed by 2005 and 2004. This knowledge could have been better used back in 2008 as many banks applied allowances without regard to vintage. The one bright spot in this downturn is that it has given the industry a torrent of data to adjust their models and experience. As this analysis revealed, early detection and understanding the magnitude of deterioration would have allowed bankers to better allocate resources and predict both capital and loan workout resources in the future.

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