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Market will improve, panel says, but not in the near future

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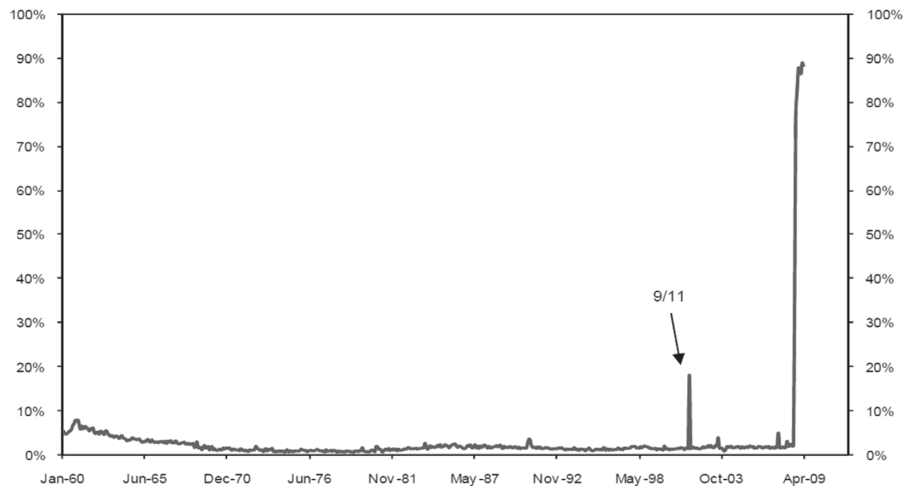
It was a candid presentation on the realities of the banking climate — peppered with occasional gallows humor — at Houston law firm BoyarMiller's "Current State of the Capital Markets" breakfast Sept. 10.

"I can see it takes a free meal to get everyone out in this recession," quipped moderator Bill Boyar, chairman of BoyarMiller, as he kicked off the forum.

Held at the Houstonian, four Houston-area financial industry veterans gave a detailed, if somber, assessment of the capital markets. Though the markets will eventually improve, they said, many will continue to falter for the near future, particularly real estate.



MERGERS AND ACQUISITIONS

Issues with raising an adequate amount of senior debt have kept merger and acquisition activity low, says Thomas Hargrove, managing director and cofounder of Houston-based investment banking firm GulfStar Group.

"There is basically a lockjaw on M&A activity," he says.

Activity has dropped sharply from its height of 18,000 deals in 2007 to a little over 2,000 in the first half of 2009.

There is some light at the end of the tunnel, however, Hargrove says. There is currently about $400 billion in uninvested capital and Hargrove says he is optimistic movement will pick up by 2010. The stock market has begun to rebound from its low in March 2009, which historically has signaled a pick up in M&A activity shortly afterward. An increasing tax environment may also prompt movement from owners looking to lower their tax liabilities as well, Hargrove adds.

'TSUNAMI' OF LOAN MATURITY

Tom Fish, vice chairman of CBRE/Melody, gave a grim assessment of what he calls the coming "tsunami" of mortgage debt that is set to mature between 2009 and 2013 — debt that cannot be refinanced in the current market.

"There is a lot of stress coming," Fish says. "We are not even in the middle of it."

According to CBRE, banks account for 50 percent of outstanding real estate debt, with 20 percent in commercial mortgage-backed securities and life insurance and government accounting agencies accounting for around 10 percent each. The remaining 10 percent is classified as "other."

The real problem, Fish says, is that from 2004 to 2007, commercial real estate loan volume was more that $1.4 trillion, three times more than the period between 2000 and 2004. Moreover, the same amount of loans is expected to mature over the next five years as in the past 15. Fish says the period between 2010 and 2013 will be one of "unprecedented stress and disruption" in the U.S. real estate capital markets, with banks being forced to take massive losses in CRE as borrowers will be unable to refinance their loans. As property values have decreased, loan-to-value ratios have dropped and net operating income has taken a hit, banks are less willing to work with distressed borrowers.

That trend has already begun, as CBRE reports that CMBS delinquency is at 6.5 percent of outstanding debt — six times what it was a year ago. The firm projects the monthly CMBS delinquency balance

to reach $50 billion by December 2009 — up $40 billion from the same month last year. Fish suggests that these loans should be modified if the bank determines that the current owner is the "best" owner for the asset.

"A lot of these loans need to, and should be, restructured," Fish says.

Borrowers should treat the restructuring "like it was new financing" and work to show the bank that it is better than foreclosing, Fish says, adding that borrowers should initiate the process at least 12 to 18 months before the loan matures so as not to be in "imminent default."

FEELING THE SQUEEZE

If panelists offered any bright spots, they came from Andrew Kanaly, chairman and CEO of Houston-based financial planner Kanaly Trust, who predicted that the recession was likely to end by the fall of 2009, though unemployment would continue to rise for some time afterward.

That said, Kanaly added that the credit crisis was now beginning to affect prime borrowers. According to Kanaly, prime products such as non-agency, jumbo and agency loans have had the highest rates of deterioration since January 2008, citing a 350 percent increase.

"There is a myth that sub-prime caused all these problems," Kanaly says.

He also raised the issue of an excess in bank reserves. In April 2009, excess reserves of depository institutions as a percentage of total reserves reached almost 90 percent, high compared to the sub-10 percent rate of the past decades. That, he says, could lead to high inflation.

Much like the previous speakers, Kanaly stressed that the characteristics of this recession were unique, and that using the downturn of the 1980s was not a good metric to gauge when the economy would ultimately recover.

"There is no history book to go back and look at," Kanaly says.

CONSERVATIVE FINANCING

From the bankers' perspective, Paul Murphy Jr., CEO of Amegy Bank of Texas, says that while loans are at high spreads with much more conservative structuring, funding is still available for good businesses. Amegy itself is down $300 million in loans and is looking for business, but Murphy stresses that credit quality remains crucial.

'We're in the second inning, and this feels like it could be a double header.'

Paul Murphy Jr.
Amegy Bank of Texas

There is very low visibility for the near future, he says. Clients should examine the structure of their accounts to make sure they are taking full advantage of FDIC insurance, as well as reaffirming the safety and soundness of their banks. Murphy also advised that since during times of economic hardship, the number of fraud cases increases, businesses should pay attention to dual controls and separation of duties to minimize fraud risk.

For the coming year, he says, the market will continue to be turbulent.

"We're in the second inning, and this feels like it could be a double header," Murphy says. ■

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