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Commercial crisis in Del.? Probably not

The state may be insulated from the next predicted real-estate fall

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Most folks probably don't spend a lot of time worrying about the empty storefronts at the shopping center down the street, or the empty office building they pass on the way to work.

Bankers and landlords, on the other hand, are thinking about those dark places a lot these days.

Across the country, there is growing fear that the commercial real-estate market will be the next shoe to drop in the limping economy. As the number of boarded-up stores and vacant offices rises, so does the possibility of Delaware getting caught in a surge of bad loans and falling property values.

While that tide certainly could touch this state's shores, it probably won't rise too high here, or last too long, local real-estate experts and observers say.

As with the housing market, the situation -- and the outlook -- is far less dire in Delaware than in some parts of the country, according to local developers and real-estate experts. In several cases, developers are even moving ahead with multimillion-dollar commercial projects in the face of global economic turmoil, certain they stand to benefit when times turn around.

In one recent high-profile announcement, local real estate developer Pettinaro Construction unveiled its vision for a 15- to 20-story office tower that will rise from the former Daniel L. Hermann Courthouse on Rodney Square in Wilmington.

And downstate, developers recently opened the Peninsula Crossing shopping center near Millsboro, anchored by a BJ's Wholesale Club and a Lowe's; and say business is booming at their nearby Bayshore Plaza center, opened last year.

"They're fully leased and going great guns," said Bob Benson, one of the partners on the projects.

The picture elsewhere isn't as optimistic.

A recent report by Deutsche Bank AG predicted a 35 percent to 45 percent drop in U.S. commercial real-estate prices this year, along with rising loan delinquencies and increasing difficulty for owners trying to refinance their loans. Those values already have fallen 30 percent from their peak in 2007, the report said.

The national delinquency rate for commercial construction loans has doubled since September, Deutsche Bank said.

One prime area of concern are loans secured by commercial mortgage-backed securities. When those loans mature, the customer may be required to inject more equity and face a higher interest rate -- a variation on the quandary faced in the last 18 months by millions of homeowners. Many might not even qualify for refinancing because of the credit crisis, the Deutsche Bank report said.

The result is a risk that banks will face a flurry or commercial mortgage defaults, exactly what they don't need at a time when their balance sheets are already in recuperation mode from the housing debacle.

In Delaware, the market is somewhat insulated against that risk, experts said. Locally based banks said they steered clear of securities-backed lending. It also helps that Delaware's size naturally discouraged excessive building, and that the market is dominated by longtime developers with less need to highly leverage projects.

"Today, I think -- touch wood -- that portfolio has held up pretty well," said William B. North, chief credit officer for Wilmington Trust.

"We haven't seen the stress on that portfolio that we've seen on the portfolios related to residential," said Rodger Levenson, executive vice president and director of commercial banking at WSFS.

Compared with the giant national banks, local lenders say, they have played the game more cautiously, relying on longtime relationships and familiarity with markets to help guide lending decisions.

"First and foremost, we are character lenders," said Brian D. Bailey, Delaware market manager for Wilmington Trust. "We look to the prinicpals and certainly our past relationship as a prediction of what the future will hold."

"Our underwriting standards and our approach to this lending has been pretty consistent," Levenson said. "We were never out there chasing transactions when the markets were frothy."

In this market, the work in advance of a project is more important than ever, both for bankers and developers. Top-notch retail projects in good locations are finding the financing and the tenants they need, insiders say.

Projects in iffier spots are struggling.

"The market today is still open for A-rated locations and projects," said Preston Dyer, one of the partners in the new Millsboro shopping centers.

"Dover, Salisbury and the beach have always been resilient to economic downturns," added Joe Reed, another partner.

In this environment, better-maintained properties will likely fare better than those on the margins, said Marvin Sachs, president of Bellevue Realty, part of a company that owns and manages retail properties across New Castle County. "We try to stay on top of it so we don't have a run-down center or a dated center," he said.

Delaware's diverse economy also protects against severe shocks, experts said.

"We're not reliant upon any one industry," Bailey said. "There's a lot of industries here to help insulate us from potential pitfalls."

At the same time, it's clear there is pressure on the market, especially at the many suburban strip properties occupied by smaller independent retailers.

The city of Wilmington finished 2008 with a vacancy rate of 19 percent, the highest of the decade, according to real estate firm Grubb & Ellis. Nationally, vacancy rates are projected to reach 16.7 percent later this year, according to the National Association of Realtors.

In at least one case, an entire office building in Delaware sits vacant -- the 54,000-square-foot former MBNA building on King Street, bought by the state for $13.4 million.

Local construction firms and architects say their businesses are scrambling for work.

As a result of the slowdown in demand, rents in the office sector are expected to drop an average of 4.2 percent nationally this year.

"We do see some pressure from some tenants that are looking to have rent concessions from landlords," said Jim O'Hara, president of Jim O'Hara Realty, a division of the Emory Hill building firm. "I think that's the biggest problem that landlords have right now."

Accommodating those requests would only make things worse for highly leveraged projects, experts said.

"The little mom-and-pop retailers are starting to hurt. I don't think that's going to get better tomorrow," said Gregory Pettinaro, CEO of the Newport-based developer.

At least for the last quarter of 2008, troubles faced by local banks was centered more on loans connected with the housing market, not commercial construction.

Still, at WSFS Financial, a handful of poorly performing housing construction loans accounted for $7.3 million -- about 70 percent -- of its fourth-quarter write-downs.

At Wilmington Trust, commercial mortgages actually boosted business in the fourth quarter, driven by customers who found that they could no longer find the discount financing once offered by specialty lenders. At the same time, about $78 million of the bank's commercial construction loans -- all of them housing developments that the bank did not identify -- went bad during the quarter.

Banks will release results for the first quarter of this year later this month.

Looking ahead, the loans most at risk of running into trouble are those made during the peak market years of 2006 and 2007, according to research by Foresight Analytics. Nationally, about $216 billion in commercial mortgages are coming due through 2012.

Nationally, that means much of the damage will occur soon -- commercial mortgage delinquencies hit an estimated 2.7 percent in the fourth quarter of 2008, and are expected to jump to 4.3 percent by the end of this year.

Well-known banking analyst Mike Mayo of Calyon Securities said last week that while banks might be nearing the end of write-downs of risky investments, they are still early in battling loan losses, predicting that the default rate on all loans will exceed that of the Great Depression.

The properties where owners are faring the worst nationally are retailers, office building owners and apartment buildings. Delinquency rates among hotels and industrial properties are rising more modestly.

Delaware's biggest shopping center -- Christiana Mall -- is at risk of getting caught as well. Its owner, Chicago-based General Growth Properties Inc., has been struggling to avoid bankruptcy for months.

Ultimately, the fate of commercial real estate can't be separated from the fate of residential, Bailey said. And in Delaware, there are signs that home sales are beginning to revive, he said.

"People are signing agreements of sale, they're not just thinking about it," he said. "We're seeing signs of improvement in that market."

Developers are adopting a wait-and-see attitude -- but say they will be ready to move forward when they get hints of a recovery. Pettinaro said he is in the process of getting approvals for retail projects in nearby Pennsylvania, "but I don't know if I'd start them right now. I think the office market's going to turn around before the retail market does."