Phases of the Tsunami

Commercial and Multifamily Mortgage Maturities

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OBSERVING A WAVE OF CRISIS

Tsunamis have several stages, the first of which is called Initiation. As shown in Figure 1.1, Initiation is when something occurs that is typically unseen and unheard but that generates the conditions for a tsunami to occur. Initiation for the commercial real estate tsunami wave headed our way was caused in part by the same kind of exuberance in the marketplace that led to the residential housing market collapse. Ownership fever spread widely, driven by economic, political, and social pressures and facilitated by enthusiastic lenders with an optimistic posture that matched the marketplace.

Wall Street then offered expanded opportunities to securitize and otherwise participate in the profit of this trend and many of the loans facilitating it. These actions echoed many of the conditions and causes that have led us to the residential real estate fiasco we are still recovering from today. The booming economy of the mid 2000s pushed commercial rents up, and
high valuation followed. Adding to the momentum was the availability of financing for commercial properties, fueled in part by commercial mortgage backed securities (CMBS). The collapse of our economy late in 2008, and the resulting fall of commercial real estate values, has left us with over $1 trillion in commercial real estate loans maturing in the next few years, and great challenges to refinance them. When did we start talking so casually in trillions of dollars like they are estimates to get our home remodeled? That answer you will find in the Amplification phase, discussed in Chapter 2.

Commercial financing through CMBS is similar in structure to the securitized residential mortgages known as mortgage-backed securities (MBS). Through the mid 2000s, as demand for commercial real estate increased, so did the need to finance it. CMBS helped fuel the availability of financing for commercial real estate throughout the nation and became part of the “Initiation” of the wave we see before us today. Despite the fact that most experts believe lending practices remained relatively conservative throughout the boom, no one could have predicted the free fall in occupancy, rental rates, and values we see today and expect in the months and years ahead. In 2009 new origination of CMBS was nowhere to be seen and seems unlikely to return to previous levels any time in the near future. Where CMBS left off, banks, large and small, all across the country took over, ultimately making loans that would later cost many of these institutions their economic lives.

It would appear commercial real estate markets are about two years behind the residential markets. In the coming years we will see a very familiar pattern of deteriorating values and industry and government intervention with a long recovery ahead. Unfortunately, during the height of the boom throughout 2005, 2006, and 2007, the underwriters of these loans continued to be very optimistic about commercial property’s stability and did not anticipate the perfect storm headed our way.

On March 26, 2009 the Wall Street Journal ran a front-page article titled “Commercial Property Faces Crisis.” In this article, the Journal reported, “The delinquency rate on about 700 billion securitized (CMBS) loans backed by office buildings and hotels and stores and other investment property has more than doubled since September.” These delinquency rates have continued to rise at an unprecedented rate. This is very similar to the conditions that resulted from the savings and loan crisis and creation of the Resolution Trust Corporation (the RTC) of the late 1980s and early 1990s. The savings and loan crisis resulted in the failure of close to a thousand U.S. banks and savings institutions. To put things in perspective, however, the lenders at the time only took about $48 billion in losses on commercial real estate debt between 1990 and 1995, representing about 8 percent of the overall debt. The U.S. banking sector could suffer ten times
those losses this time, with the possibility of more than 700 banks failing as a result of the commercial real estate foreclosures that lie ahead. Consider the momentum of devaluation potentially impacting the overall commercial real estate market. That’s just the beginning. Of the $500 billion in commercial loans held by smaller community banks, a large percentage could not be refinanced if they were due today, and that’s just what will be maturing between 2010 and 2013!

Estimates are that about two-thirds of the estimated $700 billion in CMBS maturities won’t qualify for refinancing. The *Wall Street Journal* article also stated, “Besides securities backed by commercial real estate loans about $524.5 billion of the whole commercial mortgages held by the nation’s bank and thrifts are expected to come due between this year and 2012. Between 40% and 45% of those loans wouldn’t qualify for refinancing in the tight credit environment as they exceed 90% of the underlying properties’ values, estimates Matthew Andersen, partner at Foresight Analytics.”

The Foresight Analytics report that much of the *Wall Street Journal* article was based on is called “Commercial Mortgage Outlook: Growing Pains in Mortgage Maturities” and is an excellent source of data on this subject. Dated March 17, 2009, the report states: “The commercial real estate market faces demand for mortgage financing, at a time when credit is very tight. This is setting the stage for a likely financing shortfall, leading to increased distress in the commercial real estate debt market and putting further downward pressure on values.” Adding, “Foresight Analytics estimates that $814 billion in commercial and multifamily mortgages will mature between 2009 to 2011 (see the figure on page 1). Commercial mortgages, at $594 billion, will comprise the bulk of the maturities. . . .” Some commercial property values have already fallen more than 50 percent from their inflated 2007 values, exceeding losses resulting from the S&L crisis of the 1990s.

McClatchy Washington Bureau posted April 29, 2009, “. . . ‘it’s the next big wave to hit. It’s the next round of bad news,’ said Scott Talbot, the senior vice president of government affairs for the Financial Services Roundtable, a trade group for big banks and other financial institutions collectively concerned about the coming problems.”

On April 16, 2009, General Growth properties filed for bankruptcy protection. The Chicago-based company owned more than 200 malls across the United States at the time. General Growth was unable to renegotiate its debts as they came due at the time of the filing.

Paul Walter, vice president of brokerage operations in North America for NAI Global, was quoted as saying, “On the street, the rumor is it is coming and it’s going to come fast and furious.” Moreover, Christopher Cornell, commercial real estate economist for Moody’s Economy.com asserts, “There
will be a further drag on the economy’s recovery.” These foreboding warnings keep coming everyday, with no end in sight.

The bad news continued to build throughout 2009: Finally, there was news that President Obama was being introduced to the issue in October when Fox Business News published in an exclusive on Friday, October 16, 2009: “FBN Exclusive: Obama Briefed on Commercial Real Estate.” The article, by Peter Barnes of Fox Business with the subtitle “Commercial Real Estate: The Next Crisis,” went on to say, “President Obama was formally briefed by his economic team recently on growing problems in commercial real estate lending, an administration official told Fox Business. According to the administration official, the economic team briefed the President on the ‘looming issue,’ an issue many believe could trigger the next banking crisis.”

Intelligent Investing published “Commercial Real Estate Will Collapse” by Stuart Saft on November 19, 2009, which stated, “The long-feared financial disaster is still looming. Bad court decisions could set it off. The commercial real estate market is on its last legs and unless drastic actions are taken, the effects on the broader economy will be catastrophic. The obvious problem is the excessive amount of debt placed on the properties and the amount of debt that has to be refinanced during a relatively short period of time.” Then this from Bloomberg.com on December 7, 2009, “No Escape from TARP for U.S. Banks Choking on Real Estate Loans,” by Elizabeth Hester and Linda Shen. “As the U.S. economy pulls out of a recession and the biggest banks return to profitability, mounting defaults on commercial property may keep regional lenders from repaying bailout funds until at least 2011. Unpaid loans on malls, hotels, apartments and home developments stood at a 16-year high of 3.4 percent in the third quarter of 2009 and are continuing to rise at an alarming rate. Nationwide, the volume of estimated commercial and multifamily mortgage maturities is also a serious concern as shown in Table 1.1.

**UNDER WATER AND SINKING FAST**

Here lies one of the fundamental challenges to the commercial loan maturity issue; while it is estimated that the total debt on commercial real estate nationwide is $3.5 trillion on an estimated $6 trillion of value, the estimated loan-to-value ratio on the majority of loans maturing between 2010 and 2013 was on average 70 to 80 percent. Keep in mind that the 70 to 80 percent loan to value ratio was established at the time these loans were originated, during the boom. Given the overall reduction in commercial real estate values, most of these loans could not be refinanced without a
TABLE 1.1  Estimated Mortgage Maturities, 2009 to 2011 in Bank and Thrift Portfolios, Commercial and Multifamily Mortgages (in $billions)

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<thead>
<tr>
<th>State</th>
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<tr>
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<td>South Carolina</td>
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Source: Foresight Analytics, LLC, 2009

considerable principal reduction by the borrower or other kind of loan workout with the lender. How many owners will opt to make principal reductions on their failing commercial real estate investments is one question; how many will have the financial ability to do it if they wish to is another.

Original loan-to-value ratios on many of the $500 billion commercial loans also maturing between 2010 and 2013 with the smaller community
banks could easily exceed the value of the property itself. Many of these loans were made to small businesses that are currently struggling with the economic conditions and are likely to fall into default in the coming months and years ahead.

Estimates of the total value of the nation’s commercial real estate range between $6 and $7 trillion. This value was driven to this level by the huge demand of the boom economy to house its businesses and workplaces. Office buildings, shopping centers, industrial buildings, and manufacturing plants are the homes of the businesses that drive our economy. Drugstores, bicycle shops, hair salons, auto repair shops, and grocery stores are places we visit daily and depend on. As the economy declines and the demand for services and products decreases, so does the demand for commercial real estate.

During the last five years of our booming economy, we couldn’t construct buildings fast enough; multiple offers to purchase or lease buildings were commonplace nationwide. If it sounds familiar, it’s because it echoes the residential real estate boom we were experiencing at the same time. Commercial real estate demand is directly correlated to growth in areas like construction, housing, and consumer affluence. Using their homes as virtual ATMs, many consumers spent more than they otherwise could have (or should have), and demand for all things retail increased exponentially. On and on it went until late last year when the startling press conferences from Washington and New York announced our economy was on the verge of collapse. No one had noticed?! The fall came with virtually no warning whatsoever.

It was a downward (or upward depending on how you look at it) spiral: Consumers over-leveraged their homes, using them as ATMs for their spending sprees. Over a period of years this activity led to overinflated sales projections, which in turn led to overinflated expectations for continued consumer demand and inaccurate projections for the demand for all types of commercial real estate—retail, office, and industrial.

A VIEW FROM HIGHER GROUND—CHARLES A. “MAC” MCCULURE, 2009 PRESIDENT CCIM INSTITUTE

A Certified Commercial Investment Member (CCIM) is one of the most recognized expert certifications in the commercial real estate industry. CCIM Institute is the world’s largest network for commercial real estate professionals. When I sat down with Charles A. “Mac” McClure, 2009 president of CCIM Institute and prolific commercial real estate broker, I knew this was going to be a great opportunity for readers to learn a few things
about what our industry is going through and benefit from the depth of Mac’s knowledge and experience. Along with being the 2009 president of CCIM Institute, Mac is Chairman of the Board of McClure Partners, a full-service real estate brokerage and development company based in Addison, Texas, part of the Dallas-Fort Worth metroplex. Mac entered the real estate profession in 1975 and was President and co-founder of TIG Real Estate Services, Inc., of Dallas, a real estate holding company set up to manage, lease, and develop real estate for pension funds, REITs, and insurance companies.

During his 34-year real estate career, Mr. McClure has closed more than $1 billion of real estate transactions and negotiated over $500 million in lease transactions. Mac is a licensed real estate broker in the state of Texas and holds both the prestigious CCIM and CRE designations. Mr. McClure has authored numerous articles on commercial real estate, is a nationally known speaker on the subject, and has managed, leased, and developed for and consulted with many of the largest pension funds and institutional investors in the United States.

The CCIM trait runs in his family as he is married to Susan McClure, CCIM, and has one son John McClure, CCIM, who are partners with him in his firm. Mac was gracious enough to grant me the following interview.

Tony Wood: Mac, you and I have been in the business over 30 years; we have both seen some very severe markets. One of the worst was working through the S&L crisis of the 1980s and the RTC program. I remember in reading about your history that you had some involvement with the commercial real estate industry’s recovery yourself during that time?

Charles A. “Mac” McClure: Yes, I was. I had originally written the troubled assets course for the CCIM Institute in 1986, and in 1986, 1987, and 1988 we called it the “REO Super Session” in Dallas, Texas, and that’s all we were doing back in those days.

Tony Wood: I would imagine you are planning on bringing something similar back to the CCIM curriculum these days.

Charles A. “Mac” McClure: We have talked about that. One problem is it is almost impossible to get your hands around what we are dealing with today. And, quite candidly, I have spent more time probably lobbying than I have worrying about that, because I represent some of the major pension funds in America. For the last fifteen years this list has included CALPers, New York State Teachers, GE Capital, various police and fire associations, State of Alaska Permanent Fund, and one of the things that I have found is the real problem today is mark to market accounting rules. In 2007 FASB passed the famous “157 rule,” which created more problems and the
biggest tsunami that has happened in the commercial real estate—really in the world economy—since the Great Depression. It was a non-governmental agency that created the problem under the osmosis of the Securities and Exchange Commission.

TW: Can you give us some detail on the FASB (Financial Accounting Standards Board) 157 rule?
CM: FASB 157 in 2007 changed the evaluation technique for any mortgage or investment vehicle for the residential and commercial real estate markets. FASB 157 set the standards that said that you had to use only one approach to value under FASB’s “fair accounting value.” Or, stated differently, an auditor who audits a pool of loans securing CMBS bonds for a pension fund, insurance company, or bank will evaluate with only one approach to value, which is the sales comparison approach—in FASB words, “Active Trading Market.” When you have no active trading market for the bonds, then the value will be written down to the level of those bonds that are trading. The accountant becomes the appraiser of the bonds under FASB 157 and has to use one of three tests: level one is active trading market, level two observable market data, or level three (with auditors’ discretion) discounted cash flow. However, accountants are not used to using three approaches to value like appraisers in the real estate industry, and when an FASB ruling comes out, they will go to the first one and use it since they feel that this is the most defensible approach.

So, in essence, instead of using the true three approaches to value that real estate appraisers use under FIRREA, FASB has basically told the appraisers of the loans to use only one approach to value, which has really messed the entire market up. We have the building being appraised with three approaches and the underlying loan with one approach—does that make sense? Hell, no.

TW: So the appraisal of the loan has no correlation with the real estate. As you said, real estate appraisers use the standard three approaches of comparable sales, replacement cost, and income approach, right?
CM: That’s right, so you have current sales of similar buildings, which is the comparable sales approach, you have cost approach, and you have income approach. The regulators ordered the MAI appraisers, “You will use them, all of them.” When my office building is being appraised under those three approaches today by the real estate appraisers, but the underlying mortgage is being appraised by another entirely different approach to value by the accountants, then we have a disconnect from the marketplace. So the appraisal for the underlying loan says you will use the sales comparable approach and maybe you can use some observable market data, and maybe you can use
some discounted cash flow, but you really need to use active trading market. Well, there was no active trading market in 2008, and by the time the auditors finished all of their rewriting of the books, every bank, every pension fund, and every insurance company in America was undercapitalized because the auditors went in and took a non-trading market and wrote down their pools of mortgages as much as 40, 50, or 60 percent of the value the year before.

So let me give you a really good example: A medium-sized police and fire association has $50 million in Triple A rated CMBS offerings, now they are at the bottom tranche of the CMBS portfolio. There's no active trading market, so the auditor sits there and says, “Well, we can’t find any comparables. The only comps we have are these deeply discounted loans that are selling, so that must be the comparable. Thus, we are going to write your pool of loans down from $50 million to $22 million. Even though it is still cash flowing, even though you’re still getting the same $3.5 million in return, and even though you have a net operating income of three and a half million dollars, we are going to write it down to $22 million.” This means that the police and fire association will now have to reserve for $30 million in losses. As a pension fund, the guy that made the investment gets to go to the firehouse and sit there and get the crap beat out of him because he quote “lost $30 million” when he really didn’t.

TW: Give me your estimation as to what the reserve requirement looks like on something like that.
CM: Just go look at loan loss reserve requirements, if you take $30 million off somebody’s balance sheet. Let’s talk about what a pension fund has to do. A bank has 10 percent capital; if it’s a billion-dollar bank, that means it has to have $100 million in capital to keep that 10 percent capital ratio. Let’s say a pension fund has to have $100 million at 10 percent or $10 million. So if it’s a billion dollars, you have to have 10 percent or $100 million.

Then all of a sudden you lose $30 million of equity on a portfolio of triple A bonds, but you were still getting the same cash flow. That means your capitalization went from a $100 million to $70 million immediately on a billion dollar fund. That's exactly what happened—that is exactly what is happening everywhere.

If you’re a $500 million pension fund, take 10 percent of that, $50 million, right? And if you took $30 million out of the $50 million does that screw up all of your ratios? Dramatically? Immediately? Now you are running around scrambling—trying to figure out how you’re going to do it, you might even have to go sell that pool.

TW: Mac, I am sure that you know as well as anyone, that while the auditors are a pain in their approach, there is some credence to the concept that we have some loss of value to deal with, isn’t there?
CM: Yes, we have loss of value. We overextended ourselves. We had a rather large segment of the population do what? They went out and got sub-prime mortgages, and there are some people in the country who shouldn’t have homeownership, period.

TW: I am sure you have seen the numbers already, this trillion-dollar wave of commercial debt maturities over the next several years, and the whole mark to market concerns that you’re addressing here. I look at it from a more fundamental standpoint because I’m not a mortgage banker, I’m a commercial real estate broker. These days I’m selling mostly commercial REOs and commercial short sales at deeply discounted prices from what their “market value” was estimated at just a year or two ago. It is very difficult to find a “market value price” because there isn’t a market anymore to get a pulse on. You said earlier, it’s hard to get your arms around the problem. It seems we’re in a free fall. Vacancy rates are skyrocketing, rental rates are plummeting, that automatically equates to reduction in values, cap rates have increased—there’s some more reduction in value, and then you’ve got this limitation on financing that’s going to strangle our ability to do transactions. These equate to real actual adjustments in value as well—don’t they?
CM: Yes, and here’s something else: My biggest problem is I’m taking these issues to Congress and I can’t get anyone to listen. Nobody wants to have a congressional hearing about it, but that’s where we are.

TW: But even if these rules did not exist, wouldn’t we still be looking at these vacancy rates and rental rates and looking at some significant decreases in value?
CM: First, I will say that California, Arizona, and Florida are kicked out of the equation—and the only reason that I say that is because I have seen—and I don’t mean this unkindly—I’ve seen a tremendous amount of speculation going on in those three markets in all product types, including residential.

Where it’s a little different is most of the rest of the country. You see a slow down, and when you see a slow down and you go into a recession, you start seeing consumer confidence waning. All that shrinks the market. Therefore, you have tenants like Circuit City going out of business, you have people in the market who are overcapitalized and having problems, but that is probably only 15 to 20 percent with problems—not 60 percent problems. And I guess that is where my problem with the whole thing is.

If you look across the board, the real estate value cycle should have been somewhere around an 18 to 20 percent correction. That means if you had a $5 million building, then you should be looking at something like a million dollar correction off that building’s value, where now it is worth $4 million.
But because there’s no accounting, because there is no way to finance the building. It’s going down even more and the mortgage underneath it has been traded at $2 million instead of $4 million.

The entire market is being run based on a panic mode instead of a real economic mode. Now you are going to see this trillion dollars (coming due). The thing that’s interesting is if we are dealing with borrowers with triple A underlying assets, generally speaking, they are going to figure out a way to renew those notes, but if you’re dealing with someone like a Dollar General deal with a “mom and pop” owner or a “mom and pop” barber shop, then that’s not going to work; they are the ones who are going to have a grave problem.

**TW:** That is what I am really concerned about. The large pension funds and REITs will find a way or die, but it’s going to be the smaller investors out there, many of the people I deal with everyday, that are really going to be impacted. The $1, $3, $5, $8 million properties. The owner-users and single-tenant, triple net leased investments, they are not going to fare well under these market conditions. Many of the small investors and small partnerships are now upside down, owing more than the property is worth. Many of these people tried to do everything right, they put 40 to 50 percent down, but unfortunately when it comes time to renew these loans, they are going to have challenges with that.

**CM:** Ninety-nine percent of the lenders and major pension funds in this country that made the participating loans in the triple A rated type office buildings are going to be okay. Those are the guys that go out and do $150 or $200 million loans, and they will be okay.

The problem I see is these $5 and $10 million deals. If you wipe out the liquidity of a $250 to $500 million bank down Main Street anywhere USA, it can’t make a real estate loan because its ratios are so dad-gum upside down.

You have a certain percentage of your portfolio, or you’re too heavy in real estate, or you’ve got too many loan loss reserves set up for the real estate because your portfolio was written down. I know of a bank that bought some really good triple A performing mortgage-backed security pools, and
they’re sucking eggs right now on their capitalization. They can’t make a loan in any real estate assets at all until their ratios come back.

TW: So are you there side by side with Real Estate Roundtable and its five-point plan, or do you have your own lobbying position, and or do you guys work together?
CM: We’re there with Real Estate Roundtable, we’re there with CMBS (Commercial Mortgage Backed Securities Association), National Association of Realtors, Institute of Real Estate Management, all of us are in there slugging it out together.

TW: Good. The commercial real estate industry needs all the help it can get these days, and we don’t exactly have the same political sympathetic ear that homeowners had in the residential sector crisis.
CM: The trouble is that the Congress of the United States spent the entire summer and fall 2009 talking about healthcare, while the rest of the world falls down on top of its head—oh yeah, we’re going to get to this next year, if we have a next year.

The future, for the next two to three years, until we see a recovery, all we see is catastrophic things, or until we see some reason that we’re going to jump out of it. From 1930 to 1940 the unemployment rate continued to be the same. In fact, for all of the New Deal efforts that FDR put in, every one of them, the unemployment rate still went up by the time they got through with all the job growth and all they were shoving down our throats. By 1939 our unemployment rate was higher than it was in 1930 and 1931. Eventually, we will figure out that shoving money out of the government trough doesn’t work, and then we’re going to have to have job growth. When we start having job growth, then this country will start coming around again—but you know we’re at a very high unemployment rate, so what are we going to do? You and I and every other CCIM in the country are going to sit there and do one thing, we’re going to be paddling water and working this out.

We have got to have job growth, real jobs, because real jobs create 3.4 percent more jobs. Then the retail sector and everything else will improve and people can start spending money again.

TW: CCIM Institute curriculum, is that going to change here in the next year? I would imagine it has to.
CM: We have dramatically changed our core courses. We just spent a tremendous amount of money and have rewritten the CCIM 101, 102, 103, and 104 core courses. We are actually using a technique in our 101 that transitions all the way through our courses now. You have two basic kinds of property that you deal with in this country, you have owner-user property and you have investment property. That’s it.
So what we have done now with our core courses is incorporate the concept of Geospatial, GIS, and Cycle Graphics. The commercial real estate space industry is finite, we know what’s available. What we need to do is begin to look at the demand side of it. What we have finally started doing is taking the available space versus how we can project demand, which creates the market vacancy for the area. Then we can start pulling it back with Geospatial graphing and Cycle Graphics and determine how to pull that vacancy back into equilibrium.

Our new four courses of the CCIM program have been rewritten because we want to be on the cutting edge. We just spent $2.6 million rewriting them, and it just so happens we’re rolling all those courses out and training our instructors in throughout 2010.

TW: Are you going to have any specialty courses on commercial REOs, on lender-client-type relations, on lease or loan renegotiations?
CM: Yes, but to be honest with you, we’re taking a more proactive approach with our core courses. Our core courses really and truly are going to dig into the, so to speak, bowels of the entire model. The supply side is pretty much finite retail, office, or industrial. Everything is out there, but what we need to find is new horizons and new corridors for demand, which is going to drive the refilling and re-tenanting of America. To be honest with you, we’re real excited about what we’re rolling out for 2010.

Number one, we’re fixing to revolutionize the industry in my opinion and we’re seeing a paradigm shift in the brokerage industry anyway.

TW: Yes—and a paradigm shift by definition means that we can’t drive the car using the rearview mirror anymore. We have to start looking ahead and figuring this out ourselves and get ahead of it.
CM: You know we’ve got 18,000 members, and quite candidly, I am really looking at the possibility of 2010, 2011 repositioning of our membership. CCIM membership will be repositioned and become the leading commercial real estate people in the United States. I see the old 50-50 brokerage model as being really top heavy, with that corporate real estate executive sitting in New York or Washington, DC, or wherever the hell they are and taking half of the [broker's fees] and the brokers out there busting their butts. I think you are going to see quite a few of these newer companies, where the broker is actually out there getting 90 percent of the revenue base, because if the tools are available to you through people like the CCIM Institute, what the hell do you need to pay half your income to somebody else for?

TW: Mac, one last question: Would you agree that in the next couple of years as this wave hits that we are going to see lenders as a new and larger client base, and that lenders are going to need to be trained as owners?
CM: Yes—in fact we’ve had some serious discussions with some of the major lending associations about trying to get them into CCIM 101 to 104 courses. In fact, I’d probably be willing to bet that you’re going to see most of the small to medium size banks in America start taking the CCIM courses.

TW: Yes or hiring CCIMs to do some of this REO work for them.
CM: Yes, but you’d have to work for them on a full-time basis.