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CMBS MATURITIES CAN BE LIKE A FALLING KNIFE

Underwater commercial real estate loans are putting senior bondholders, even some pension funds, at risk.

By Ann Hambly

According to Webster's dictionary, "falling knife" is a slang phrase for a security in which the current price or value has dropped significantly in a short period of time, or where the shares of a company become worthless.

Investopedia describes a "falling knife" as an investor buying into a market with a lot of downward momentum — a stock that drops precipitously as the equity ownership is reduced to nothing.

The commercial mortgage-backed securities (CMBS) industry is facing a falling knife scenario today.

More than \$300 billion in CMBS loans will mature over the next three years, according to New York-based Trepp LLC.

In some of these cases, the outstanding loan balance exceeds the value of the property.

The property type and geographic location may vary, but the general circumstances are similar.

What follows is a hypothetical example that reflects what occurs when owners realize their properties may be upside down when the current loan matures.

The property is a 122,000-square-foot office building in a sunny city in Arizona.

In 2007, the borrower, Sentient LLC, went to its lender, On The Move, and secured a new 10-year, interest-only loan for \$12 million.

After all, the property was worth well over \$15 million at that time. It

was 100 percent occupied and the major tenant was Legal Tender, a large bank. Legal Tender had a lease expiring at the end of 2017.

Unbeknownst to Sentient, On The Move put its loan in a commercial mortgage-backed securities (CMBS) pool.

Consequently, the ultimate owner of Sentient's loan was a large pool of bondholders that would remain unknown to Sentient.

On The Move would no longer be able to help Sentient with any future requests the borrower might have on its loan because it no longer owned the loan.

Delaying the Inevitable

When the market crashed in 2008, Sentient got lucky and managed to escape unscathed, mainly due to the long-term lease in place with Legal Tender that included above-market rents.

However, the problem will hit when Legal Tender leaves or renegotiates its lease at expiration.

In 2011, Sentient needed to get a lease modified. Since the lease modification required lender approval, Sentient went to its originator at On The Move to discuss.

Of course, On The Move informed Sentient there was nothing that it could do as the loan was now in a CMBS pool.

After many months and much frus-

see CMBS page 36



McCarthy Building Cos. is currently constructing the Museum of Fine Arts in Houston. The project is a renovation, expansion and addition to the museum's existing 14-acre campus, with an 80,000-square-foot school for art students and a new exhibition hall.

GENERAL CONTRACTORS EXPECT STRONG YEAR

2015 will be a strong year for construction, oil prices could slow 2016.

By Haisten Willis

General contractors experienced a strong 2014 as the seemingly unstoppable Texas economy pushed revenues ever higher and crane after crane filled skylines across the state's metro areas.

That same trend will almost certainly continue through 2015. While factors such as low oil prices and materials costs could slow growth in 2016 and beyond, general contractors are breaking ground on major projects and growing business across all property types at the moment.

"The past 12 months were very strong for McCarthy," says Bobby Campbell, vice president of pre-construction at McCarthy Building Cos. Inc., a St. Louis-based construction

firm with offices in Dallas and Houston. "We saw solid growth across each of our product types in Texas. Specifically, our healthcare and commercial teams in Dallas and Houston saw double-digit growth in revenues in 2014, and we expect similar results in 2015."

Another firm, VCC Construction, which has worked in all 50 states and opened a Houston office in 2014, also expects growth this year. The company grew 15 percent in 2014, reaching \$694 million in revenue.

A good example of the firm's recent work in Texas is in the River Oaks district in Houston. The mixed-use

see CONTRACTORS, page 37

INSIDE THIS ISSUE

Grand Parkway Marketplace
Finds New Market

page 24

Tax Credits Aid in Rehabilitation
Projects

page 26

NewQuest to Begin Construction on
Retail Center in Houston

page 10

Construction Completed on BMW
Dealership in Fort Worth

page 28

GENERAL CONTRACTORS EXPECT STRONG YEAR

CONTRACTORS from page 1

development is set for completion this fall and includes 252,000 square feet of retail, 92,000 square feet of office space, a multifamily component, an eight-screen movie theater and several restaurants. The project caters to an affluent customer, with retailers such as Tom Ford, Christian Dior and Dolce & Gabbana.

Michael Scheurich, president and CEO of Arch-Con, a Houston-based construction company, says his company grew about 20 percent in 2014, jumping from \$100 million to \$120 million in revenue. He expects the firm, which operates solely in Texas, will see \$150 million in revenue this year.

About 40 percent of Arch-Con's business is in the hospitality sector. The company is currently building an Embassy Suites hotel in The Woodlands, a suburb north of Houston. The 9-story project will have 207 rooms when it's complete.

"The Woodlands has a huge need for hotel rooms," says Scheurich.

But there could be a slowdown in 2016 and beyond. Some larger projects, according to Scheurich, are already being put on hold due to uncertainty in energy prices. Scheurich says several planned office buildings on Houston's west side ranging from 150,000 square feet to 300,000 square feet have been temporarily halted. Because those larger projects are more complicated, they carry more risk and can sometimes be held up when issues arise. Low oil prices could become one of those issues.

Crude oil sold for \$99.53 per barrel on July 1, 2014. By late January that price plummeted to \$44.37 per barrel, and stood at \$49.30 per barrel as of this writing.

Oil Price Raises Questions

Because developments are planned so far in advance, the construction industry is one of the last parts of the

commercial real estate business to feel the effects of economic swings.

"Construction is kind of the tail on the dog," says Scheurich. "Everyone is trying to get their projects out the door right now. With oil prices being a little shaky, most folks are hoping to get projects moving forward as fast as possible. You're going to see construction companies do well in 2015. In 2016, that's where you're going to feel the impact of what's happening today."

The U.S. economy began improving soon after the great recession began, it wasn't until 2014 that the wave hit construction firms. In one respect, this means contractors are shielded from any short-term effects low oil prices could have on the economy. By the same token, if there is an oil-based lag, which could threaten the Houston area in particular, contractors will again be last to pull out of it.

For the last few years, Houston has been one of the hottest areas for new construction in the entire country. McCarthy is currently constructing the Museum of Fine Arts in Houston. The high-profile job is a major renovation, expansion and addition to the museum's existing 14-acre campus.

McCarthy is adding a new 80,000-square-foot school for art students, two parking garages, a 164,000-square-foot exhibition hall, a tunnel connector and a renovation/expansion of the Cullen Sculpture Garden.

The project is slated to begin this summer and will be complete in 2019, ensuring a source of steady work for the firm for the next four years.

"We were selected to build this monumental project because of our team, and due to McCarthy's long-standing history of building complex, architecturally significant projects in the entertainment and arts industry," says Campbell, who is optimistic oil prices will rebound soon.

McCarthy's history of building

projects like the Museum of Fine Arts bodes well for the company, so long as those types of projects are coming to market.

For much of Texas, the booming shale and energy stronghold of Houston propped up the economy during the downturn. Oil prices could easily shoot right back to above \$90 per barrel, where they were this time a year ago, but until that happens there will be some uncertainty in the Lone Star State's economy.

Oil prices aren't the only challenge for general contractors in Texas. Because the economy is constantly in flux, it is always difficult for general contractors to project three or five years forward. There is the cost of materials, the availability of skilled la-

bor and the overall health of the U.S. economy to contend with, all of three of which are in constant flux.

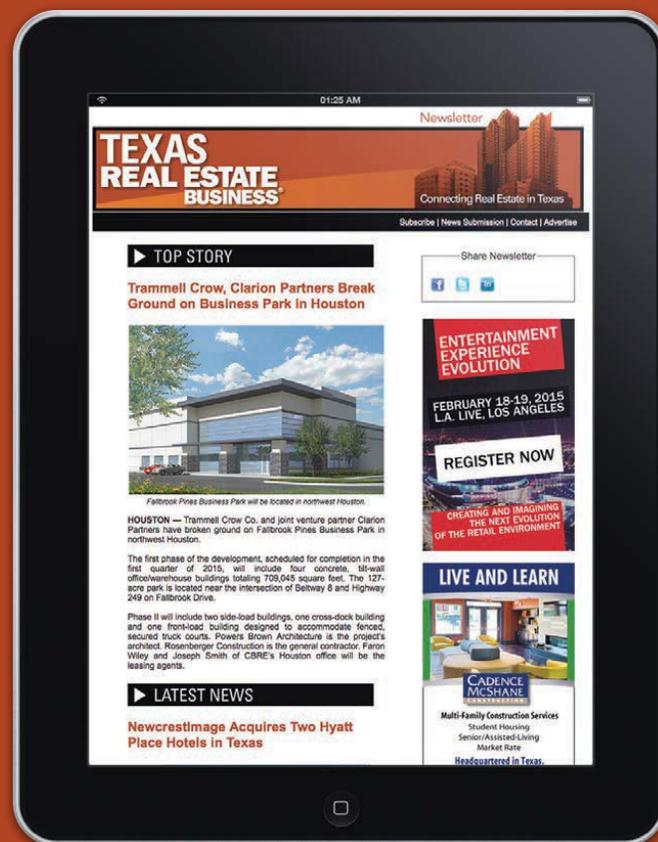
Derek Alley, senior vice president of VCC, has a positive outlook about construction prospects even if prices continue to hover around \$50 per barrel.

"If there is a correction of sorts, there is still a lot of pent-up demand in a lot of the markets that will sustain growth even in the worst case," he says.

Material Costs Rising

One of the foremost factors affecting construction firms is the cost of building materials, which changes how cost-effective development will be at any given time. This factor con-

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One of Arch-Con's current projects is a new Embassy Suites hotel in The Woodlands, a suburb north of Houston. The 9-story project will have 207 rooms when it's complete.

flicts with the long-range nature of the construction business as projects take years to plan and execute but the cost of materials constantly fluctuate.

Contractors prepare for this challenge by utilizing projected escalation percentages based on historic trends, and partnering with subcontractors and vendors early in the design process. For now, materials are rising at a manageable rate, according to the professionals interviewed for this story. Alley also notes that if oil prices stay down for an extended period of time, it could also lower the cost of materials.

According to the Engineering News-Record, the price of steel has risen 1.9 percent in the past 12 months, while the cost of cement has risen 5.7 percent and the cost of lumber has jumped 6.6 percent.

Labor Questions

There has been a shortage of skilled labor in Texas construction firms for some time. This too relates to the oil boom, as workers could make higher pay doing similar jobs in the oil industry. According to the sources interviewed for this piece, in many cases both industries are in need of the same type of workers.

Scheurich estimates some workers could pull in two or even three times as much driving a truck, for example, in the oil industry compared to working on a construction site. The irony is that depressed oil prices could benefit the construction industry.

"With the decline in oil and gas field operations, some of the field employees who are being laid off are coming back to construction," says Campbell.

To some, labor is the single-biggest question mark in the general contracting business. There are several reasons for this conclusion.

On one hand, many employees in supervision and management roles left the industry during the recession as the economy lost its pace, and not



Bobby Campbell
Vice President of Pre-Construction,
McCarthy Building Cos.



Derek Alley
Senior Vice President,
VCC Construction



Michael Scheurich
President and CEO,
Arch-Con

all of them have returned. Some had been in the industry two or three decades and have since found other opportunities.

"A lot of who we recruit now is younger people who want to grow in our company," says Alley. "It's more important to emphasize employee retention rates now. It's also important to invest in training, mentoring and growing talent because less people have long-term experience now than in the past."

On the other hand, millennials in some cases are pursuing fields such as technology, engineering or social media — fields some might consider more exciting — rather than go into the construction business. When they do enter the business, they are sometimes reluctant to take an entry-level position.

"Everybody coming out of college

"With the decline in oil and gas field operations, some of the field employers who are being laid off are coming back to construction."

— Bobby Campbell, Vice President of Pre-Construction
McCarthy Building Cos.

wants a management position," says Scheurich. "That sounds cynical, but it's really hard to recruit into the trade right now."

Campbell points out that many high schools are incorporating more college preparatory curriculum in lieu of a vocational curriculum, which leads more students toward enrolling in college rather than entering trades after high school graduation.

On the plus side, younger adults today generally have a higher proficiency with new technology than older adults, and advanced construction techniques make tasks that used to require extensive training into something that can be learned relatively quickly.

"A plumber, for example, in the past would have to be trained on sweating copper," says Scheurich. "You had to learn and practice it. Now plumbing is moving toward using plastic, flexible pipe. A worker can more or less stick it together and it doesn't take a lot of training. That's an example of where our industry is going."

How Tech Helps

Year after year, new techniques and tools emerge giving contractors ways to save money and build more efficiently. These tools improve both the quality and safety of the construction process.

In the near future, don't be surprised to learn about technologies that sound like something out of a sci-fi movie coming to a hard-hat site near you.

"We're seeing our industry reinvent itself at a faster pace than it ever has before," says Alley. "We're looking at virtual reality and being able to scan an entire three-dimensional model from a smart phone. For pre-construction planning and the submittal process, we're seeing technology where clients can walk around a simulated building in a virtual reality environment. They can get a feel for the space before it is built."

Alley also points out that smart devices equipped with cameras can enter parts of a construction site that would not be safe for a human to visit.

A less exciting but no less important trend is the increased versatility of tilt-wall construction.

"We're moving to five and six stories with tilt-wall construction," says Scheurich. "We're increasing the percentage of glass and the panels are getting taller, thinner and stronger. This allows us to put a lot more glass in them. It's a very economical method of building both office, industrial and retail properties."

Another ongoing trend in new construction, which has its roots in technology, is the number of projects being built to Leadership in Energy & Environmental Design (LEED) specifications, which is a green building certification.

One such project is the \$648 million Fort Bliss Replacement Hospital in El Paso, located on the state's western edge. The project, which is being built to LEED Silver standards, was awarded to both McCarthy and Clark Construction Group in May 2013. The hospital and clinic, set for completion in 2016 along with the rest of the project, are designed to achieve LEED standards for healthcare.

The 1.1 million-square-foot healthcare campus will replace the existing William Beaumont Army Medical Center. The new project will consist of a seven-story hospital, two clinics, an administrative building, a clinical investigation building and a utility plant.

"The project team will incorporate sustainable elements into the campus, including water-efficient landscaping, water-use reduction fixtures and other energy-efficient design features," says Campbell.

Questions remain for 2016 and beyond, but for the rest of this year general contractors expect solid growth,



The River Oaks District is a mixed-use development set to open this fall in Houston. The project, which is being built by VCC, includes 252,000 square feet of retail, 92,000 square feet of office space, a multifamily component, an eight-screen movie theater and several restaurants. River Oaks caters to affluent customers in the area.