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The new reality – capital forecast 2008

Every new year brings with it a unique sense of renewal. Once a year, we can wipe the slate clean and, with renewed enthusiasm, start again to improve our personal and business lives.

However, in the business world, that new hope for progress and profit is burdened by the same old baggage carried over from the past year. This year, more than any in over a decade, the baggage in the market for commercial real estate finance is heavy. The upheaval in capital markets in mid-2007 has derailed exuberant markets that were fueled by plentiful and cheap money and loose underwriting standards. A new reality in the capital market is just settling in and is likely to last for most of the coming year.

The best news for 2008 is that commercial real estate capital is still plentiful and is well priced by almost any historical measure. However, the new reality for investors, owners and developers is that all lenders are being much more selective and the cost of capital is increasing.

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The past decade's largest capital provider, the investment banks (CMBS lenders/conduits), have been forced by the bond-rating agencies to curtail the easy-money machine that created so much profit for the banks and so much value for commercial real estate owners. Capital from Wall Street will likely be constrained for at least the first six months of the year.

This will be most severe in the first quarter as the CMBS (Commercial Mortgage Backed Securities) lenders attempt to sell the huge backlog of bonds they still carry on their balance sheets. Many of these lenders are now standing on the sidelines since they have no means of providing credible, competitive quotes without clearing their inventory of bonds. Many CMBS lenders are continuing to quote businesses to try to maintain a reasonable pipeline but their pricing and underwriting criteria can change daily.

Borrowers may not know what the final loan terms will be until just before closing. Early rate locks that used to be easy and cheap are more difficult to find. What has been a very efficient market, where an investor could find a good loan simply by making a couple of calls to a few well-known conduits, has become extremely limited and fraught with risk. This provides all the more reason to consult with a professional mortgage banker to search and critique the available capital sources.

The new reality is that underwriting standards for virtually every lender will be more conservative in 2008. CMBS lenders will pull back on loan dollars, cash out and have interest-only periods until the rating agencies and secondary market investors are satisfied that the industry will control itself and its tendency for excess. However, as time passes and the deal flow and competition increases, the active conduits are likely to push the limits of rating agency tolerance to again compete for the best loans and sponsors. This will make their quotes more attractive but don't expect a return to the easy money of the past.

The portfolio lenders (i.e. life companies and regional banks) and the agencies (i.e. Fannie Mae and Freddie Mac) will continue to cherry pick the huge volume of proposals that are being sent their way. These lenders have been consistent, steady and reliable players in the market for over 40 years and will continue to look at the reasonable sustainable fundamentals of real estate as a basis for underwriting.

The net effect of these new underwriting standards will be a shift in the overall capital stack for projects. Owners and investors will need to adjust their expectations accordingly. At least for the near term, more equity will be required for new projects so the overall cost of development capital will increase.

Many new and existing lenders have abundant funds to fill this gap, so there will be little problem obtaining the capital. Relative cost for this capital will definitely be a factor to consider. Also, unless there is a large amount of built up equity in the project's historic land basis, many borrowers may need to find new equity partners and may ultimately have their ownership position diluted. cre