

Keeping commercial real estate finance in perspective

Background

In April of this year, a special report was issued by Moody's, one of the largest commercial mortgage-backed securities (CMBS) rating agencies. It said, across the board, credit underwriting quality in the CMBS market had deteriorated and that subordination levels (risk pricing) had to increase to reflect the inherent risk. This happened at the same time that deterioration in residential sub-prime paper was producing huge losses in hedge fund portfolios and other investors in this sector. Traditional buyers of commercial mortgage-backed bonds reacted and began significant "kickouts" of deals perceived to be too risky for the pricing. As the sub-prime residential crisis spread, a growing sense of dread, and ultimately panic, quickly permeated the commercial CMBS market as well. Bond issues



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going to the market found fewer buyers and yields on the bonds and had to be re-priced higher and higher to attract the few available investors. Ultimately, it became difficult to find buyers at any price. These concerns culminated in mid-August when the CMBS lenders still in the market increased quoted spreads to levels not seen since 1998 and new deal flow ground to a halt.

Where we are now

The events of the past 60 days have created huge disruptions in the tra-

ditional capital flows for commercial mortgages. One of the major sources of finance for commercial deals, the investment banks (the conduits), has seen investors in its securities virtually vanish, forcing them to hold huge volumes of bonds on their balance sheets. Market uncertainty forced them to increase quoted spreads by over 100 basis points during this period, one of the largest and fastest market moves in almost ten years. Any investor or developer who had a deal under application in the conduit pipeline in August and September, was most likely affected. Many deals were ultimately restructured and re-priced to the detriment of the borrowers.

What happened in the CMBS market is fundamentally a forced de-leveraging and a re-pricing of risk. Underwriting standards have suddenly returned

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to a more conservative approach existing at least three years ago. Although it is very painful for the investment banks that can't sell the bonds, and somewhat painful for borrowers that have to pay more for their capital, it is not a "market meltdown" as many have asserted. It seems that fear, not fact, has driven the recent market disruption. There has been no negative credit event in the underlying real estate to justify the exit of the bond buyers.

A sense of history provides perspective, even in the financial markets: Markets do cycle and occasionally crash. Today's situation, however, appears to be a temporary and healthy adjustment in a large sector of the financing market. It will be disruptive for many but ultimately should bring back a level of sanity to a market sector that got out of control.

The fundamentals of the commercial real estate markets are still generally strong. Delinquencies are near all time lows. Vacancies are still quite low for most property types and most properties are still showing real growth in rents. There is still plenty of capital available at very attractive interest rates despite the wider spreads.

Points to Ponder

- Conduit spreads have widened since early August from about 110 b.p. over

Treasuries to about 190-215 over the index.

- Life insurance companies and other portfolio lenders have also widened their pricing by 50 basis points or so to the range of 160 to 180 over the Treasury index.

- The net effect of wider spreads is less than all the noise would indicate due to dropping Treasury indexes.

- Some lenders (both conduits and life companies) have pulled out of the market, refusing to quote new deals until some stability returns to the market.

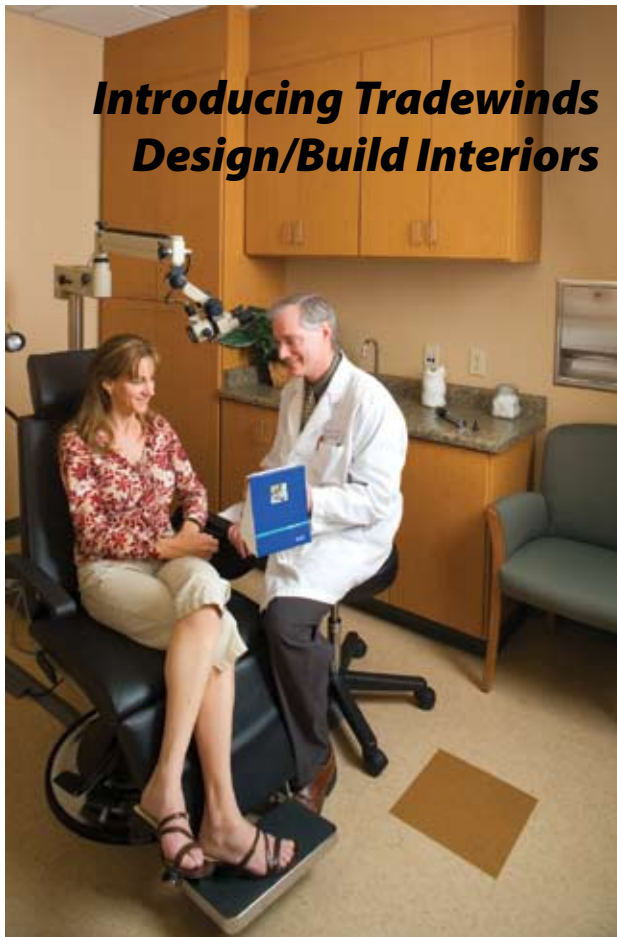
- Most conduits are still quoting deals but at much wider spreads to give themselves some protection against the market volatility. Since there are few buyers for the bonds, they really don't know what the market pricing should be for the risk. However, if you need to refinance and can tolerate some market volatility, conduits are still viable financing options. They will still likely generate higher loan dollars and better net cash flow than the portfolio lenders even at current spreads.

- Portfolio lenders (life insurance companies, banks and credit companies) and the agencies (Fannie Mae and Freddie Mac) are gaining market share. Life company pricing is now better than the conduits and they can still do what they do best: tailor a flexible loan to match the borrowers objectives. They are

much more relationship oriented and are easier to deal with now and during the life of the loan. Banks and credit companies are good short-term lenders if some recourse can be provided. The agencies are still the favored lenders on multifamily deals.

Conclusion

As a borrower, maintain your perspective. These are not the best of times but they are far from the worst of times. Even if you missed the opportunity to refinance your project with an interest rate with a 5 in front, consider that you can still get long-term financing in the low-to-mid 6% range from a wide variety of sources. These are still very attractive rates based on historic standards and may create value for your investment in the longer term. Take a realistic approach to negotiating your next deal. The market can be merciless to those who think they can outsmart it. Also, consider using an experienced mortgage banker to sort out the available financing options, present the best structure available and assist you to get your loan closed efficiently. Having a reliable consultant to help you navigate through the current minefield can add real value to your investment and will allow you to do what you do best — run your business. **cre**



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