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Back to basics: Better times are ahead for the solvent balance sheet lenders

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We all now know about the credit crunch that has dismantled the CMBS world in short order and the sub-prime losses that have felled the Wall St. chieftains and the legions of origination and support personnel sitting at their desks (for now) updating their resumés.

Due to the bad news coming from those now idle risk-reward challenged lenders, we see for the first time in many years a decompression in loan spreads and a return to "back to basics" underwriting.

The intense competition created by the conduit world in the past has vanished in the blink of an eye providing an opportunity for the portfolio lenders still standing to make up some lost ground, and lost profits. We are seeing for the first time in many years, a much more sober underwriting and pricing approach as lenders are enjoying their new found freedom to choose from a greater numberof available loan requests and price them accordingly. Construction lenders aside for the moment, the permanent lenders have adjusted in a number of ways: The once easy-to-get "interest only period" is now much harder to come by and although still available in certain circumstances, not used in analyzing debt coverage ratios (i.e. although a few years of I/O may be granted within the loan term, the loan amount will be limited by a DCR calculated on a 30-year amortization schedule). Loan to values (LTVs) which were stretched way beyond 80% in the past based upon assumed future value creation have been replaced with lower LTVs and an analysis of actual "in-place" cash flow. The "loan stretches" of recent past now have to have a "real good story" and a sponsor who has displayed a track record of executing a business plan in order to get consideration. Regarding rates, we have seen a widening of spreads in the non-CMBS world of anywhere from 50 to 100 basis points as lenders are demanding a more reasonable reward for their risk. CMBS spreads have widened way beyond that.

Construction lenders have adjusted their underwriting criteria even more so. All builder/developers are finding it much tougher to attract the level of "A-note" construction debt they once did. More and more construction lenders are requiring a larger equity or mezzanine contribution while non-recourse construction financing for small to mid-sized spec jobs is non-existent. Here too spreads have widened as borrowers are returning to those once slightly higher priced lenders they once shunned. Once again, the development team and the financial strength of the guarantors are being looked at more closely as project execution and financial ability to carry a job becomes more important. There is a general sense in the market right now that value appreciation cannot be depended upon to fix mistakes made, so it better get done right the first time. Case in point: We are seeing some of the construction loans originated 18 to 24 months ago starting to approach maturity as completion remains beyond that date. In the past, developers were rewarded for being behind schedule as a rise in valuation greatly exceeded cost overruns. Consequently, what would have been a failed residential rental development became a wildly profitable condominium project as the market soared. (Today no one is predicting that kind of run up in market value, conversely we are in a more bear-minded market nationally, and we are starting to see construction loans that are "out of balance." This is a situation where there is not enough hard and/or soft cost allocations remaining in a loan budget to complete the project).I feel that the next 18-24 months will be a very telling time about the quality of the next real estate cycle.

In closing, as many non-traditional lenders have exited the market, an opportunity now exists for certain relationship lenders to recapture market share and establish new relationships with quality borrowers who will hopefully not forget who stayed the course when the waters got choppy. Profits will follow.

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