nyrej

How should we react to the changes of the real estate capital market?

September 26, 2007 - Upstate New York

As summer has drawn to an end and the traditional post-Labor Day activity begins, we find ourselves in a vastly changed real estate capital market. Over the past 90 days, the markets have experienced sharp and sometimes unsettling changes, larger than in the fall of 1998, which have left lenders and borrowers alike looking for answers. Re-pricing, loan cuts and increased amortizations have lately become commonplace. In the longer term, many experts now predict changes in cap rates, growth trends and overall underwriting standards. How should we react? One industry newsletter (Wachovia Capital Markets) notes the following:

* Assuming current financing conditions persist, we expect monthly fixed-rate conduit origination volume to drop 75% through the second half of 2007 as underwriting standards have tightened substantially.

* Conduit lenders have cut back lending significantly, proving financing only for their best (longest) clients.

* Properties are increasingly being underwritten again in-place revenue rather than pro form a.

* In the first half of 2007, 86% of conduit loans included an IO period. Most new loans are amortizing with fewer, if any, IO periods. The net effect of a loan going from IO to amortizing is a 100-120 bps increase in the mortgage constant on average.

* More equity is being required, at lower loan-to-values.

* Borrowing costs have increased. Market participants indicate that the spread of the coupon rate over the 10-year treasury rate has increased from around 115 bps (conduit) and approximately 130 bps (non-conduit) in H1 2007 to current spreads of around 200 bps (conduit) and 175 bps (non-conduit), respectively.

Wachovia provides a good summary of the recent past. But where do borrowers go now and what should they expect?

* Borrowers should look again to life insurance and bank relationships to fill the void and provide greater certainty of execution in the near term. Such balance sheet lenders have been less upset by CMBS market. Look to them to provide solid financing in the near future.

* While spreads for all the lenders have widened considerably, the benchmark 10-year treasury yield has decreased by about the same amount. Overall rates to borrowers are therefore virtually unchanged.

* Borrowers should expect the norm for loan-to-value to look more like 75% versus the 80% LTV we have experienced.

* Underwriting standards will become more stringent.

* Response time will slow as the volume of new deals is being pushed to fewer lenders.

* Longer amortization periods with significant interest-only periods will become the exception rather

than the norm. 25 to 30-year schedules will be the new norm with shorter amortization periods likely.
* Critically, lenders will look to stronger deal fundamentals to distinguish among projects in a more selective lending market. Borrowers with strong track records and solid underwriting will stand out to lenders today more than ever before.

When this "credit crunch" will end is certain. Today there is a very large backlog with CMBS loans yet to be securitized and sold, in addition to the large volume of "B" pieces also for sale. A market-clearing price will establish, the backlog will disappear, and commercial real estate lending will more closely resemble the established past, but it will take time. Until then, we need to change focus, look to more traditional lending sources, and most important, push forward on strong fundamental deals, and quality will always rise to the top.

Daniel Monte is the president of The Rose Hill Group of WNY, LTD, Buffalo, N.Y.