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Why the commercial mortgage market will not be the next sub-prime market

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The price decreases we are witnessing in the commercial mortgage market can be partly attributed to the belief that delinquencies and losses are quickly escalating. Many participants, especially CMBS investors, believe the recent slide in the commercial mortgage market could mirror the sub-prime (residential) market decline. However, there are several key features of the commercial mortgage market that should prevent it from experiencing the complete disintegration the sub-prime market faced in the second half of 2007:

* Underlying Commercial Real Estate Fundamentals Remain Strong: The commercial real estate market holds a relatively strong position today despite the current economic environment. Nearly all areas of the country are experiencing low vacancy rates with rental growth across most property types. If rental growth slows, cash flow generated by these properties will continue to increase due to the staggered rollover of leases.

* Better Underwriting: The deterioration in commercial mortgage underwriting standards needs to be put into perspective. An estimated 40% to 45% of sub-prime loans issued in 2005 and 2006 were "no documentation" or "limited documentation" loans, meaning little attention was paid to the borrower's financial background. On the commercial side, the accuracy of rent roll and financial information has not been as problematic despite aggressive underwriting on rental rates and income growth. This trend applies to smaller loans as well. There are very few cases of misrepresented financial information for loans of less than $2 million.

* Borrower Profiles: A large number of commercial mortgage borrowers were overly optimistic about future cash flow and took advantage of available leverage. However, most of these borrowers are well-capitalized commercial real estate investors and are generally more sophisticated than sub-prime borrowers in their understanding of the risks and equity at stake in securing such large loans.

* Price Appreciation: Price appreciation has not driven as many defaults in the commercial real estate market as we have seen on the residential side. A decline in property valuations due to changing debt markets and altered growth projections will not trigger a surge in loan defaults for commercial properties. As long as the cash flow generated by a property is sufficient to pay debt service, there is no reason for a borrower to default.

* Interest Rate Resets: The structure of interest rate resets in the commercial mortgage market differs greatly from that of the sub-prime market. The majority of commercial mortgages have fixed interest rates and average terms of seven to ten years. The commercial mortgage equivalent of a sub-prime reset is the partial interest-only (IO) loan, whose debt service increases as it converts to amortization. Because the majority of the partial IO commercial mortgages were sized based on the amortizing debt service payment, these resets will be a manageable issue. If the incremental,

principal increase in debt service is driving a commercial borrower to default, the lender can remedy the situation by allowing the loan to maintain its IO status.

Not only is the commercial mortgage market considerably different than the residential sub-prime market, the underlying commercial market has significantly improved since 1990:

* Supply Remains Mostly in Check: The availability of newly constructed space is much lower and manageable today than it was 20 years ago. Supply is more controlled due to a significant increase in construction costs, making the acquisition of existing properties more economical than new construction. Not only have increased construction costs limited the amount of new buildings, they have contributed to the appreciation of commercial property values in recent years. Limited supply can also be attributed to stronger lender discipline and the fact that lenders are now hesitant to offer construction loans without significant pre-leasing or pre-selling.

* Availability of Information: Market information is much more readily available today than it was 20 years ago. This relatively new phenomenon has made pricing of commercial mortgages more transparent and subsequently improved the efficiency of the markets. Furthermore, the CMBS and REIT markets have grown substantially, allowing lenders to re-price mortgages before they incur any delinquencies or losses.

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