Examining the future of the commercial mortgage market

February 06, 2009 - Financial Digest

There is no doubt that the country is entering 2009 mired in the worst recession in decades. With the currently instability of the banking and financial systems, the question on many of our minds is: what does the future of the commercial mortgage market hold?

The commercial mortgage market became significantly more leveraged in the last five years because loans were issued based on the assumption that future income would grow. Many deals closed with the help of mezzanine debt, pushing leverage over 90% and fueling the increase in real estate values as well as the compression of cap rates. This era of high leverage is gone, and I am confident it will be replaced with a rational lending matrix. Where 75% to 80% leverage seemed to be the norm over the past five years, we are now looking at levels close to 55% to 60%. The impact of this conservative leverage will be felt in every aspect of the market. The most obvious impact will be on the need for additional equity, which translates to lower prices across the board.

The securitized lenders (CMBS), who have been the most aggressive lenders of the past ten years, have completely disappeared from the market and are not expected to return anytime soon. This has removed a major provider of debt to the real estate industry. Many of the major lenders such as Wachovia, Lehman Brothers, Merrill Lynch, Bear Stearns have ceased lending and the ones that are left are still saddled with commercial mortgages that they were unable to securitize. When CMBS lenders do come back to the market, they will take on a much more conservative format.

Besides lower leverage becoming the norm, another major change from the past few years will be the shrinking absolute dollar amount of commercial mortgage debt. This will result from a drop in value of commercial real estate properties and the smaller amount of debt secured by those lower values, combined with more conservative leverage.

The commercial mortgage market has grown significantly in five years, from $2.1 trillion in 2003 to $3.4 trillion at the end of the 3rd quarter 2008 (source: Federal Reserve). However, many of the mortgages maturing over the next few years may not be refinanced in full due to the drop in property values and the market's reduced leverage structure. According to research done by Prudential Real Estate Investors, the amount of mortgages outstanding could shrink by 15% or $150 billion over the next several years. As has been discussed in previous columns, this void needs to be filled by either incremental equity increases or the utilization of mezzanine capital.

Current de-leveraging will cause real estate values to fall because the increased need for equity and/or mezzanine debt will force buyers to pay lower prices to meet their return hurdles. It is difficult to say how low values will fall, but based on the current disruption in the credit markets, I predict decreases in the 20 to 30% range from the highs reached in 2007.

The impacts of falling values and lower leverage are already being felt in the market. Many borrowers with maturing mortgages are unable to refinance out their existing debt. A lender may be willing to extend the loan if the borrower has been current on payments and the cash flow from the

property covers debt service. This will increase the chance of the loan maturing at a time when the commercial mortgage market is in better shape. Many lenders who are not as optimistic about the future and need additional capital for themselves often opt for discounted payoffs from borrowers instead of extending the loan or foreclosing on the property.

In response to this new phenomenon, many organizations have sprung up to work with borrowers in need of debt or equity, to help them buy back their debt. In many cases, the borrower is "crammed down," with their equity subordinated to new equity or mezzanine debt. In this particular scenario, they are able to keep control of the property and generate management and/or asset management fees from the property.

Johnson Capital recently created a new group, Johnson Capital Special Servicing, which works with borrowers to help them negotiate with their existing lender. So far, we have assisted in modifying existing loan terms, and have coordinated the purchase of notes by borrowers or with fresh capital brought in by a third party.

For those with the stomach and the available capital to buy in the current market, there are opportunities to purchase at substantial discounts. A number of owners and borrowers who purchased properties at inflated prices in 2006 and 2007 are unable to pay off their existing debt at maturity or work with the existing owner to help them re-capitalize their property. As a result, they are extremely motivated to sell in these very challenging times.

Daniel Lisser is a managing director of Johnson Capital, New York, N.Y.