

While new credit may be difficult to find, existing loans are being offered at reasonable discounts

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While this article is supposed to be about the outlook for the 2008 real estate industry, the savvy reader will be struck by how much space is devoted to credit market status and projections. Members of the real estate community with gray hair will recall a time when our industry was "in its own orbit". Historically, real estate cycled, but rarely in sync with the rest of the economy: it either lagged or led. Today, especially with how intrinsically real estate is capitalized via capital markets, an erosion of investor confidence in the seemingly unrelated world of corporate, asset backed and sub-prime bonds, has direct and lasting impact on the commercial real estate world. Hence, a real estate outlook without a capital markets overlay would be like a review of next year's NFL season without mentioning the New England Patriots!

During a late 2007 Mezzanine Debt Conference, much of the discussion centered on the current credit market chaos. Concern was expressed that the lingering credit crisis is leading to significant layoffs in the financial sector, which in turn has cascading effects on layoffs in supporting industries. The lack of credit manifested itself in the fourth quarter, with institutional sales dropping to a fraction of the prior year's levels. However, it appears that many issuers are working diligently to clean up their portfolios. While new credit is still difficult to obtain, many existing loans are now being offered at reasonable discounts. This is a good sign for the markets since "accepting the pain", recognizing portfolio miss-pricing, and the freeing up of lending ability needs to occur before any "normalcy" can return to the markets. The loan discounts are delivered in two popular ways: A) absolute principal discounts against legal collectable note amount, B) Below market financing. Absolute principal discounts are for both credit and rate adjustments. For example, an issuer makes a \$20 million 85% loan-to-value (LTV) bridge loan at LIBOR +200. Today that loan should be priced at LIBOR +400. This might require the loan to be sold at \$18 million. In addition, if the loan was poorly underwritten with very aggressive lease-up assumptions, such that even at \$18 million the real LTV is 90%. This would result in an additional discount of \$1 million. Therefore the note in this example would be sold for \$17 million. These discounts are typically just for rate adjustments. For example, an issuer makes the same bridge loan in the above example, but here there is no credit impairment. In this example, the issuer sells the note at Par, with 80% financing at LIBOR. This allows the buyer to get the appropriate yield for this loan. Some are criticizing the latter discount process since it does not actually remove the asset from the issuer's portfolio, it simply pays it down slightly and re-characterizes it. It is unclear if such structures will actually obtain sales treatment for the seller and free up new lending power. The rocky road to recovery in the Credit Markets continues as lenders and issuers make progress detailing their troubled assets in early 2008. Tremont's survey of industry participants reveals that most feel the market is at least 75% through disclosure of problem assets. Historically, Credit Crisis's become exasperated when "bad news" filters out over long

extended periods. Drawn-out revelation of bad news has a tendency to erode market confidence across sectors. We are coming up on the one-year anniversary of when the subprime crisis news broke out on a national scale. The first half of 2007 saw the failure of many companies who were active in the subprime industry. Since then, the business press has regularly identified various Funds with super-leveraged esoteric investments that have failed; probably the most publicized being the several Bear Sterns funds that were dissolved. To date, well publicized "bad news", combined with individual net worth declines from the weak housing market, have finally combined to cause the US consumer to slow spending, leading to the present risk of a widespread recession. To date, the commercial real estate credit crisis has been predominantly a function of the frozen securitization market, caused by investor loss of confidence in underwriting and bond ratings. Noteworthy is the fact that the underlying commercial real estate assets have largely continued to perform with relatively low vacancy and rising rents. Furthermore, commercial mortgage backed securities are enjoying delinquencies below 1% for all asset types. The risk for 2008 is that the looming economic downturn or recession will eventually lead to actual real estate related problems and potential defaults, creating a whole new series of new "bad news"; just as the original causes of the credit crisis resolve. Hopefully, the recent aggressive action of the European Central Bank in providing \$500 billion liquidity to the market, in tandem with Fed chairman Bernanke's statement to resolve to use his office to fight off a recession, will successfully keep a recession to a minimum and help to avoid a downturn in real estate fundamentals.

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