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## **Capital markets over the past ten years provided significant liquidity for commercial real estate**

September 18, 2007 - Connecticut

Aldous Huxley in his novel Brave New World wrote "These are unpleasant facts; I know it. But then most historical facts are unpleasant."

The current upheaval in the real estate capital markets has many pundits drawing comparisons to unpleasant credit market events of years past. Whether it is 1998, 1991, 1987, 1929, or even 1907, people are looking to the past for answers to today's questions about credit market conditions.

Suffice to say, while each was a period of substantial economic turmoil, each event was a result of a particular set of circumstances that occurred and caused the tumult. For example in 1991 the commercial real estate lending industry was in full crisis mode as the savings and loan industry was insolvent with commercial banks and insurance companies not far behind. Coupled with an incredible over supply of product, a weak economy, little or no demand for commercial space, and a tight money supply it is no wonder that access to mortgage funding suddenly dried up and we had a full scale credit crunch.

The real estate credit market meltdown of 2007 will take its own place in the annals of economic history precisely for one reason: not an overall lack of liquidity but a re-pricing of risk. Re-pricing that better reflects the true underlying risks in the commercial real estate sector and more specifically in mortgage lending. A new old paradigm where lenders use sound underwriting that properly reflects asset risk and return or "the ability to sleep at night" test.

The capital markets over the past ten years have provided significant liquidity for commercial real estate. At the same time delinquency rates on mortgage loans have decreased to negligible levels. According to Commercial Mortgage Alert annual US CMBS issuance has grown from approximately \$16 billion in 1995 to over \$213 billion in 2006. Even with the current unsettled conditions, new issuance is likely to top \$250 billion in 2007. The Standard & Poor's U.S. CMBS delinquency rate is currently .3% vs. its peak of 1.96% in December 2003. The low delinquency rate can be attributed to the record-breaking amount of new CMBS issuance and the confluence of positive economic factors over the past several years. These include healthy real estate fundamentals, abundant liquidity for real estate lending and purchases, and stable long-term interest rates.

Loan pricing has gotten cheaper every year and leverage and loan terms more aggressive as CMBS investors began to believe that mortgage loans were truly a commodity. This liquidity in turn has led to cap rate compression and massive price appreciation at the asset level. Real estate sector participants have enjoyed the benefits of a lender block party over the past few years drinking risk blinding "Kool-Aid" to excess. Borrowers of mortgage debt have been the beneficiary of aggressive underwriting and a willingness of lenders and investors to accept spreads at far below any historical precedent.

Always at work in the real estate sector is the greater fool theory or the premise that an investor

makes questionable investments without any regard to quality with the hope of quickly selling them off to another investor (the greater fool), who might also be hoping to flip it quickly. Until now there was always a refinancing or a sale available for real estate market participants. Unfortunately, a change in perceived risk creates a dislocation in the capital markets. We are in the midst of a major dislocation.

The concept of risk and real estate mortgages began to gain traction when the "subprime crisis" began to gain traction in the early spring of this year. It accelerated in the late spring and over the summer months as rating agencies, and investors began to reevaluate loan underwriting and their assessment of perceived risk.

As a result, there is a major correction in commercial mortgage pricing that reflects risk and return. Spreads have increased by as much as 100 basis points in the CMBS market and as much as 50-75 basis points in the life company market in the month of August alone. All-in spreads are generally 175 to 225 basis points over matching treasuries - ironically a level that is not that much different from the 1980s and 1990s. Interest rates are still in the 6.25% to 6.75% range - very competitive in historical terms.

The duration of the dislocation depends if the market psychology turns from disappointment into desperation. We hope the real estate capital markets are in the midst of a controlled burn as investors take stock of what has gone on during the past few years rather than an out-of-control wildfire, where a boom and bust threatens the long-run health of the market. As Winston Churchill once said, "A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty. For I am an optimist - it does not seem to be much use being anything else!"

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