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A simplified explanation of the sub prime melt down and its effect on the commercial RE market

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A recent email from NHAR presented a table of home values by New Hampshire counties for the period 1998-2007. The point was that New Hampshire home prices doubled in 7 years or an average increase of 16% per year. The recent statewide decline of 1.9% in 2006 and 1.6% in 2007 is modest in comparison to the historic appreciation. Two things can be taken away from this comparison. First, New Hampshire and New England are in better shape than some areas of the country. Second, the hype on CNBC and other media is overdone. A story talking about a drop in housing prices of less than 2% will not attract many viewers and likely not sell lots of advertising. If it bleeds it reads! Even NPR picks up on this feeding frenzy of dire news.

I came upon a copy of House Lust: America's Obsession With Our Homes by Daniel McGinn in the local (non chain) bookstore. Authored by a Newsweek magazine writer, it is a quick read. The value of American homes rose by 3 TRILLION dollars in this period! My favorite part was the interview of the new homeowner in Potomac, MD. She couldn't remember if her new 9,000 s/f home, where she had been living for 6 months, had 6 or 7 full bathrooms! It certainly has been a robust period for homeowners! Alas, what is too good to be true is usually too good to be true. We are now reading about a housing bubble. An economic bubble where commodities, real estate, stocks or bonds, is a rapid expansion of prices which can drop precipitously with only a small prick of the bubble/balloon. Is gold worth $1,000 an ounce? Is Google worth $600 a share? Are new vinyl clad McMansions priced at $590,000 worth $250 per s/f? The answer is yes, in the short term. But market forces are powerful and while we may not understand all the variables, markets do self correct sooner or later.

There is not so much of a direct correlation between housing prices and the values of commercial real estate, but there is a commonality, which is the credit markets. The sub prime melt down is indicative of a number of new financial tools which created leverage in the markets. At the risk of over simplifying, consider the following. Home prices in exciting cities like San Diego, San Francisco and eventually Los Angeles, New York, Washington, D.C. and Boston, began to climb as demand grew and the shortage of land, along with rising construction costs pushed starter home prices over $300,000 then $400,000 then $500,000 now $600,000 to $700,000. How does one afford a $700,000 starter home? Not with a 20% down ($140,000) 80%, 30 year mortgage at 7%. So lenders came up with creative mortgage products to meet the demand for these homes. First 40 and 45 year amortizations (people move/sell every 6-7 years on average), then 90, 95 100 and eventually 105% financing! As housing prices continued to escalate, the sense that the house could be sold for more than the loan value led to more relaxed underwriting standards. The low doc and no doc loans were those without traditional confirmation of credit history, job stability, income verification or credit reports. Consider 5 of these substandard loans being mixed in with a pool of 95 standard ones and having that pool of loans being rated based upon the standard loans only and sold at a price ignoring the risk of the substandard loans. The concept of safety in numbers would mitigate the risk and convince the rating agencies. With less risk these pooled mortgages could pay lower interest to the investors considering the risk reduced rating. Lower interest rates allowed mortgage borrowers to buy more house or pay more for existing homes! Suddenly everyone is in the game and we are producing more housing units than we can absorb to the tune of 500,000 a year! Some borrowers lose their jobs, can't pay, default on the mortgageâ€”oops. The only problem is that there are now hundreds of billions of dollars of these mortgage backed securities (MBS) that financial performance is being questioned on. Investors put up the money to originate the individual mortgages, aggregate them into a pool then slice and dice them into "derivatives", making the income streams more fungible where risk related values for the income streams are sold to other investors in tranches (a tranche has the least risk and might pay 5%, the B tranche might pay 6%, the C tranche might pay 7%). Depending upon the subordinated levels for each tranche different yields are required predicated upon the risk associated with each subordination level.

This worked so well in house mortgages, why not do it with commercial mortgages too! Now we start talking real money. Take 50 office buildings with a $40m commercial mortgage loan originated in the same manner and we have $2b of securitized debt Commercial Mortgage Backed Securities (CMBS) being sold to investors. The bond insurance companies guarantee that the underlying mortgages were good debtâ€”AAA or AA and are on the hook if that turns out not to be the case so the ripples from the sub prime residential mortgage loans become tremors in the commercial lending sector. Suddenly Bear Stearns doesn't want to loan to J. P. Morgan Chase because they are not sure the mortgages that (MBS or CMBS) are offered as collateral are liquid and worth their face value. The credit market begins to lock up. The Fed has no choice but to jump in and help out by providing liquidity, because the economy is already slowing down and we do not want to slide into a recession.

It is the butterfly's wings starting a chain reaction that causes a monsoon on the other side of the globe.

This narrative has been grossly over simplified, but the connectedness and interrelationships are real. So as we head into Q2 we are not really sure how this will all play out. Clearly lenders are battening down the hatches. They want more equity, more conservative appraisals, tighter covenants, more guarantees. The risk is that an over correction on credit policies can throw a spanner in the works, and that a sudden tightness in credit can set off other problems in a stressed economy. This is not to say that is what is going to happen, but just the possibility has business owners on edge. By Q3 we should have a much better idea of what the end of the year will look like.

Remember, buy low, and sell high!

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