

Commercial real estate lending 2008: This is like deja vu all over again

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The social philosopher Lawrence Peter (Yogi) Berra once said that "You can observe a lot just by watching." When asked about a hitting slump he was experiencing he said simply, "Slump? I ain't in no slump. I just ain't hitting."

We have observed much over the past year just by watching the goings on in the real estate capital markets. The lending landscape has dramatically changed as a lending market psychology of disappointment now borders on desperation. Once considered gospel truth, credit agency ratings have come into doubt as investors did not believe agency models effectively and appropriately evaluate risks for investors. Lending spreads have been very volatile and several well known commercial real estate lenders have exited the market. Certain commercial real estate debt investors such as commercial real estate CDOs and structured investment vehicles (SIVs) no longer exist.

The current credit crunch, which began in mid 2007 when investors began to truly understand the subprime residential mortgage crisis, has deepened in response to slumping conditions in the U.S. economy. Large commercial banks and Wall Street firms are originating new loans at a fraction of the loan volume they did from late 2006 to early 2007. New lending volume is down 90% in the CMBS sector alone. While portfolio lenders like insurance companies and banks have been very active taking advantage of this dislocation, a lending gap currently exists that has yet to be filled.

Obviously, lenders just ain't hitting!

According to a report recently published by Goldman Sachs there continues to be a gap between the pricing of assets, both real and financial. Though conditions have improved somewhat since the start of 2008, buyers and sellers still have some distance to go before pricing efficiency is restored and normalized lending begins.

We believe that market should be of hope - not desperation - as there are positive signs in the commercial real estate sector indicating that sound investment and lending will continue.

* Federal Reserve action finally turned aggressive in March. Their actions have stabilized financial markets and credit spreads for the time being.

* Most commercial real estate sectors are entering this year with comparatively low vacancy and several years of healthy rent growth. This will help in absorbing any market turbulence.

* The current environment is best defined as a transition from unsustainable, frothy conditions to a normalized market. Though rising cap rates will affect values, those buyers with reasonable long-term owning strategies will benefit from a dearth of competition for assets as high leverage buyers wait on the sidelines.

* There has been a major deleveraging and repricing of risk in commercial lending. Gone are loans with 80% LTV ratios, sub 100 basis point spreads, and interest only payments. Generic pricing

ranging from 230 to 280 bps over treasuries, LTV ratios of no more than 65% and amortization of 25 to 30 years are in. Fixed mortgage rates of 6.25% to 6.75% are common for the right deal. Mortgage lending rates are still near 40 year historic lows.

* Debt capital is constrained but is available and across a wide spectrum of lenders. Transactions are occurring across markets and property types for realistically priced assets. New lending standards are more responsible and sustainable.

* Commercial real estate loan delinquency rates have increased in the past 12 months but are at less than 0.5% and near all time historical lows.

For borrowers and lenders, the rest of this year and into next year will provide some interesting opportunities and challenges. Unlike the last prolonged credit crunch of the early 1990s that was caused by massive overbuilding, the commercial real estate market today is generally well balanced and well positioned to weather the current economic storm. Conservative lending will continue where lower loan to value ratios, faster amortization, and higher debt coverage will likely be the norm. Investors with financing needs will have to meet these challenges head on in order to achieve desired financing levels.

Whether it is a large or small loan, NorthMarq Capital, Inc. and its network of 29 offices has the lending resources to help our clients meet these challenges daily.

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