

Capital markets: real estate has been re-priced for both debt and equity and that is a good thing

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Capital remains available for real estate investment. What has changed is that debt capital is being priced to better reflect risk. In all likelihood, we will manage through the current imbalances but for an alternate view, it might not be a bad idea to Google "Minsky Moment" which posits, "Are we at the end of the credit cycle where consistent loosening of credit standards has led to a crisis?"

There is evidence to support Hyman Minsky's thoughts. Moody's issued a white paper warning on underwriting in April of this year. Then in August things began to unravel with defaults in both the residential mortgage markets (sub-prime and adjustable) and the newly created Collateralized Debt Obligation "CDO" market. A Merrill Lynch paper that re-emphasized the risk in underwriting and flaws in the securitization system followed the Moody's white paper. The essence of the papers was that no one in the chain that created these instruments had any risk and the ratings agencies were bidding against each other to rate the issues. Compensation for rating a CDO was considerably higher than compensation for rating a CMBS issue and again the rating agencies competed for the right to do the rating.

The result has been a loss of confidence in the rating system itself. Some hedge funds invested in CDO's have declared bankruptcy and buyers of AAA tranches have had total losses. The CMBS market remains in turmoil. A large overhang of unsold issues is clogging the system. While buyers exist for the rated tranches and the unrated tranches, there are few buyers for the in between below investment grade tranches. The CMBS market will eventually stabilize, albeit at much higher spreads, but this may take a while given the loss of confidence. Rating agencies are scrutinizing collateral more carefully and are concerned about their liability. More troubling than this is the large overhang of unsold commercial paper, which will restrict corporate borrowing as well as merger and acquisition activity.

We have had a great run! More capital has been available to those who earned a living from commercial real estate than any time in the last century. Owners of commercial real estate could choose: a sale at the most aggressive capitalization rates in history; a conservative first mortgage at the lowest interest rates in thirty five years; participating debt structures; joint ventures; or a combination of first mortgage and mezzanine that would take capital requirements to near zero. Developers of commercial property could joint venture, forward commit, obtain open-ended construction loans and even land loans in the marketplace. There was fixed rate and floating rate money.

When the above were combined with commercial real estate markets that were and are fundamentally sound, it could not get better. Securitization added liquidity and Wall Street continued to innovate with products including Collateralized Debt Obligations and synthetics. CDO's allowed borrowers even more flexibility in that substitution of collateral was an option to defeasance or yield

maintenance. With these products, an investor could invest in REIT's, a NAREIT index, or synthetic vehicles in addition to individual assets, a portfolio or tranches in a securitization. Investment was also available in a wide variety of acquisition and debt funds.

Commercial issues offered interest only and variable rate loans based on historically high values. Collateralization provided debt at 80% of rating industry value and interest only financing at cyclical low interest rates for terms of up to ten years. Simultaneously debt service coverage declined; synthetic products (CDOs) added counter party risk. Creation of Tenants in Common (TIC) ownership allows up to 35 investors in the same asset to avoid capital gains. Dilution of experienced intellectual capital in the industry made it all seem normal. Private funds subscriptions were offered and managed by "music majors" with only one apartment investment in their "portfolio".

Residential borrowers were able to leverage their homes to historic levels. First time buyers could obtain 100% financing with little or no documentation of their ability to pay. Speculators in the condominium market were able to obtain interest only and negative amortization mortgages. Everyone believed that increased value of their home would allow them to refinance at lower rates. Many loans were sold immediately to Fannie Mae, Freddie Mac or into a private label security. Residential brokers and lenders forgot the loans they were selling had a provision that required either a guarantee of repayment or a buy back of the loan if there was a default. This caused the bankruptcies in the industry as the poor underwriting turned into defaults and lenders lacked the liquidity to meet the demands. This has forced re-pricing in the bond market to reflect the risk. Another sobering thought is that year over year home prices have fallen for the first time since the 1930s.

In all likelihood, the capital markets will adjust with some help from the Federal Reserve and re-pricing of debt capital will better reflect the relative positions of debt and equity. This will take some time as it did when Long Term Capital management nearly crashed the markets in October of 1998. The period for stabilization is anyone's guess but it will certainly take through the end of the year to settle down and probably longer into the first quarter of 2008.

Portfolio lenders such as the life insurance industry are selectively filling the void. They offer better spreads albeit at lower loan to value on better quality assets. Interest rates remain well under 7% for investment grade property. Capitalization rates have increased 50 to 60 basis points to reflect the increased cost of debt but many sellers are not yet believers resulting in lower transaction volume.

Real estate has certainly been re-priced for both debt and equity and that is a good thing long term. Perhaps we are not at a Minsky Moment.

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