

It is time for borrowers and lenders to adjust the "sails", opportunity awaits on the horizon

July 28, 2009 - Spotlights

Did you ever notice the parallels between part IV of Henry Wadsworth Longfellow's *The Theologian's Tale* and the ongoing credit crisis? Follow me here...

"Ships that pass in the night, and speak each other in passing, Only a signal shown and a distant voice in the darkness."

See the parallels? Try replacing the word "ships" with borrowers and lenders and read the verse again. Although taken out of its original context, this verse aptly illustrates the state of borrower-lender affairs after 18 months of stagnancy in the capital markets for commercial real estate. The good news? The second quarter was defined by the fits and starts of economic recovery and borrowers and lenders - the industry's proverbial ships in the night - seemed to be passing each other with greater frequency by quarter's end.

Underwriting:

Notwithstanding signs of improved liquidity coming into view on the horizon, lenders' underwriting remained rather conservative during the first half of the year. To begin with, proceeds levels available for new deals are shadows of their former selves. In a perceptible shift back to pre-commercial mortgage backed securities (CMBS) basics, life companies are underwriting to 50-60% maximum loan-to-value ratios for most core product types with the ability to get more aggressive on multi-family. While commercial banks have the ability to push proceeds further up the capital stack, 75% loan-to-value financing is still the exception, not the rule. Given considerably tighter coverage ratios, as well as falling values, borrowers shopping for loans should be prepared to bring extra cash to the table.

As the market drifts toward safer harbors, lenders' fear of making a bad loan has swayed their underwriting. When structuring loans, originators will consider the overall credit quality of the rent roll with a particular focus on tenant renewals and rollover risk. Market vacancy, credit loss assumptions, management fees, and pro forma rent growth will also be deeply scrutinized. And forgive the cliché, but it's still about location, location, location.

From a borrower's perspective, once the be-all and end-all of a winning quote, spreads on whole mortgages have receded in prominence as deals are now won on certainty of execution, servicing, structure, proceeds and recourse requirements.

Of the major property sectors, multi-family is a diamond in the rough. Apartment fundamentals have been the most stable throughout the recession and macro-economic and demographic trends support a positive long-term outlook beyond 2009. In that respect, government agencies and enterprises such as Fannie Mae, Freddie Mac, and the U.S. Department of Housing and Urban Development (HUD) have returned to form. Fannie Mae has typically followed an 80-20 ratio, by which 80% of guaranteed loans are sold while 20% are held on its books. This ratio became

inverted in the past decade, and Fannie and Freddie's balance sheets swelled to unsustainable levels.

As the agencies regain their equilibrium and renew their focus, investors have started to come back to the GSA-sponsored mortgage-backed-securities market. Multifamily investors would be wise to take advantage of historically low rates in the 5.5% range, with considerably higher leverage and debt service coverage ratios than are available via private placement.

Aside from GSA lenders, life companies and banks have emerged as the permanent lenders of choice at mid-year - and while their buckets of money are neither big nor deep, these institutions are doing deals, albeit selectively and at very conservative numbers.

The Yield Curve:

Indicative of a steepening yield curve, a widening differential between short- and long-term yields for U.S. Treasuries was noted during the first half of the year. Although rates are still low relative to historical standards, all eyes will be on the Fed and how it manages long-term rates over the second half of 2009.

Historically benchmarked to comparable term Treasuries, spreads on whole mortgages have not risen in lockstep with the yield curve. This suggests that lenders have been pricing to absolute returns with lower effective spreads for permanent fixed-rate mortgages the logical result of this pricing strategy so long as yields continue to rise.

The yield curve should be monitored closely, however, as a prolonged period of rising yields might precipitate a return to benchmarking off of Treasuries as lenders see their margins shrink - particularly on the longer end of the maturities spectrum. In this scenario, longer-term debt would become more expensive to originate as the differential between effective spreads on new whole loans and "risk free" government debt narrows. This would lead to wider spreads on longer-term debt, making shorter-term financings with options to extend much more attractive - at least in the near- and medium-term.

Longfellow's counterpart, Oliver Wendell Holmes wrote, "we must sail sometimes with the wind and sometimes against it - but we must sail." So to the ships passing in the night, it's time to adjust the sails, opportunity looms on the horizon.

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