

## Real Estate Capital Markets Update – February 8, 2008

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NOTE: Due to vacation schedules, the next issue of ULI's Real Estate Capital Markets will be published on or about February 29<sup>th</sup>.

#### **Special Comments: Notes from “The Punch Line...”, published by Abraham Gulkowitz**

(Headlines and data in “The Punch Line” come from widely available publications including national and international newspapers, trade journals, economic and industrial bulletins and websites.)

**Brace Yourself...** Massive stimulus packages, both on the monetary and fiscal sides in the U.S., have combined with talk of capital infusion to further support troubled segments of the monoline insurers - and all quickly assembled in order to put a floor under debilitating market sentiments and perhaps engender a turnaround. There was much discussion about whether the American economy would enter into a troubled recession and what effect it would have on the rest of the world. In an effort to stave off what seemed like a broadening financial panic, America's Federal Reserve cut its key interest rate by three-quarters of a percentage point, to 3.5%, the biggest single cut in a quarter of a century. The unusual intervention, a week ahead of the Fed's scheduled January meeting, soothed nerves in American markets when they reopened after a holiday. And a push to offer fiscal stimulus was quickly offered up in support. **So many of current stresses are unprecedented in scope that even in the face of market rebounds, one needs to worry whether more pain was around the corner.** The failures in mortgage finance with all its intricacies of financial engineering are actually troubling precursors of what may still unfold in the world of business credit. So many layers of debt have been created in recent years and packaged and syndicated under the very best of circumstances that unraveling this web when business opportunities shrink will be no easy task. It is noteworthy that the majority of leveraged business loans today trade below par, an amazing about face from the past few years when virtually every loan traded above par. And the gap between where loans and bonds are trading may be a harbinger of more corporate stress that is on the way. Given all the financial ingenuity and complexities, the level of corporate stress will be way higher than the official count of defaults. Beware the contagion.

**The Risks...** The Federal Reserve policy minutes reveal the extent of their concerns and they run deep. Not only were mortgage-related losses impairing balance sheets at major financial institutions, the policymakers were also worried about credit losses spreading out to credit cards, auto loans and other forms of consumer credit. These potential losses were leading to tighter credit standards for most lenders. Balance sheet pressures could also be exacerbated by concerns over “rating-agency and regulatory capital requirements.” In addition, banks were experiencing unanticipated (and unwanted) growth in loans because of illiquidity in the market for leveraged loans. In other words, banks could not sell loans that backed leveraged buy-outs, and these loans were now unexpectedly adding to capital requirements. **Some members of the Committee worried that an “unfavorable feedback loop” could develop** in which deteriorating credit market conditions would restrain economic growth further,

leading to additional tightening of credit and even slower economic growth. Such a development “could require a substantial further easing of policy.”

### **Bond insurers spark new fears over credit crisis**

Fears that the credit crunch might be entering a traumatic new phase grew yesterday as investors lost confidence in the insurers that guarantee payments on billions of dollars in bonds. Shares in Ambac Financial and MBIA, the world's biggest bond insurers, fell 52 per cent and 31 per cent, respectively, as Moody's Investors' Service raised the possibility that both might lose the triple-A credit rating on which they depend. The sector was dealt another blow when Merrill Lynch said it was writing down \$3.1bn in hedges with bond insurers, mostly with ACA Capital, a guarantor that has lost its investment-grade rating and needs to raise \$1.7bn by today to avoid insolvency. The triple-A credit rating of the bigger bond insurers is crucial because any demotion could lead to downgrades of the \$2,400bn of municipal and structured bonds they guarantee. This could force banks to increase the amount of capital held against bonds and hedges with bond insurers - a worrying prospect at a time when lenders such as Citigroup and Merrill are scrambling to raise capital.

### **Analysts predict it could be a long time before money markets return to normal**

“We’re not going to go back to normal,” were the grim words of a New York money market trader in early December, as central banks prepared to pump billions of dollars into the inter-bank markets to revive liquidity. Their efforts gave some temporary relief and the cost of short-term borrowing fell, but traders and fund managers believe it may take until the second half of this year for liquidity to return to this part of the market. Pressures are worse than Y2K or the advent of the Euro. Even with the passage of year end spreads remain elevated. Our take is that central banks have put the financial system on life support.” Unlike in 1998, during the Russian Ruble crisis and the collapse of hedge fund Long-Term Capital Management when money markets continued to operate normally, these markets, among the most liquid in the world, froze overnight in August.

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### **Private Real Estate Debt Capital Markets**

First big worry;...pricing; second big worry...capacity.

Pricing first. Spreads in the conventional, portfolio/balance sheet lender market (65% loan-to-value ratio, 1.2 +/- debt service coverage ratio, covenants, amortization, funded reserves, and underwriting based upon in-place income and expenses) seem to have stabilized, for the moment, in the ranges shown in the following chart although there is limited anecdotal evidence of actual term sheets being circulated and application letters being executed. While some have expressed consternation—actually they were more expressive—as to the width of spreads given demand, the strength of real estate fundamentals, etc., the downward path of the 10-year Treasury has effectively muted most of the impact of the widening in spreads.

## Indicated Spreads for Conventional Commercial Mortgages (as of January 31, 2008)

Property Type	Commercial Mortgage Rate Spreads for 5-10 Year Fixed-Rate Mortgages	
	<65% LTV	>65% LTV
Multifamily	+170 – 200	+180 – 240
Regional Malls	+170 – 190	+180 – 220
Strip/Power Centers	+180 – 200	+190 – 250
Multi-Tenant Industrial	+180 – 210	+190 – 230
CBD Office	+170 – 210	+195 – 225
Suburban Office	+180 – 200	+220 – 250
Full-Service Hotel	+180 – 220	+200 – 300
Limited-Service Hotel	+190 – 210	+220 – 300
	5-Year Treasury-2.80%; 10-Year Treasury-3.61%	
Source: Cushman & Wakefield Sonnenblick-Goldman, LLC.		

The securitized commercial mortgage market is not quite so benign with spreads continuing to widen, regardless of the path of Treasury yields. The following survey, effective January 26<sup>th</sup>, was provided by CohenFinancial:

Loan Term	Treasury Yield	Spread	All-in Cost
5 Year	2.54%	4.17%	6.71%
10 Year	3.42%	3.21%	6.63%

The second big worry is capacity (or overall availability) of lenders to “lend”. Based upon the volume of transactions last year, which was a record year even though the markets were “closed” for a portion of the year, the markets have come to depend upon the securitized markets for as much as 80% of the long-term capital used to finance the real estate business. Estimates for 2008 show the life insurance sector committing a high of \$50 billion to commercial and multifamily mortgage financing market and the conduit sector committing a similar amount. So...capital will be dear, hard to come by, rationed, constrained, and expensive...say it any way you want.

Not surprising are the results of the Federal Reserve Board’s most recent **Senior Loan Officer Opinion Survey** which indicated continued tightening of lending standards for all “sizes” (large, medium, and small) of commercial and industrial borrowers as well as for all forms of residential mortgage finance. The survey also noted weaker demand for commercial [real estate] mortgage loans.

Moody’s Economy.com noted in its analysis of the survey that when banks were queried as to why they had “tightened standards on C & I [commercial and industrial] loans during the period [October 2007 to January 2008], most banks cited a more uncertain or less favorable economic outlook, worsening of industry-specific problems and a reduced tolerance for risk”.

And speaking of reduced tolerance for risk, Economy.com noted: “The January survey also included a special question on the outlook for loan quality in 2008. The majority of the respondents expect to see further deterioration in loan quality in 2008. Between 75% and

85% of respondents expect deterioration in the C & I loans. A similar percent expect to see weakening in mortgage loans, while 70% expect credit quality in both credit cards and other consumer loans to worsen". Ugh!

Opportunities or Anguish? Analysts are beginning to try to quantify the issue of refinancing risk, which together with depressed homebuilder stocks and single family lot deals, seems—at present—to the opportunistic plays in the cycle. According to Realpoint, approximately \$25 billion of securitized commercial mortgage loans are maturing in the ensuing 12 months. Our sense is that we do not have to worry too much about loans written before 2004 being able to be refinanced as enough time has gone by for improvement in property fundamentals to offset weak and/or aggressive underwriting.

But, the 160+ loans which have an aggregate loan balance in excess of \$19.0 billion+, that were funded during the “heady” days (high loan-to-value ratios, low debt service coverage, interest-only, few covenants, etc.) certainly could face difficulty in the current lending environment and therefore represent opportunities for well-capitalized investors to assist “over-leveraged” borrowers in getting their financial house in order—at a price.