A Snapshot of Commercial Real Estate Financing in a Time of Uncertainty Circa 2008

By Rob Hellman and Jake Lamstein

The more things change, the more they remain the same. For those who have been in the real estate industry for ten years or more, financing real estate transactions at the end of 2007 looked a lot like it did before the capital markets got so creative. But the market took us on a six-month roller coaster ride in 2007 and there's no certainty the ride is over. What we can say is that increasingly real estate has become a liquid asset that can trade on more than just the underlying fundamentals. And because of that, there really is no return to the way things were.

Capital movements are so quick and so global today that what follows is merely a short-term snapshot, but anyone considering an acquisition or new development needs to take into account the current environment. The good news: Real estate has become an accepted asset class for investors worldwide; so today's environment should be viewed as a (relatively) short-term transitional period that may present better opportunities for long-term players whose main focus is the business of real estate. More good news: transactions have been closed during this transitional period, although the market is demanding a much higher degree of selectivity in deals that can get done.

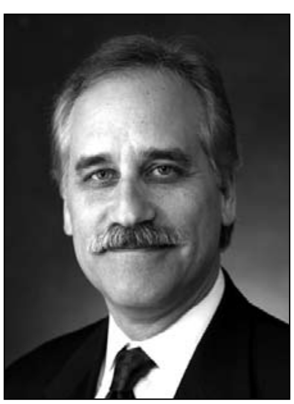
Consider: Early in the second quarter of 2007 it was still possible to create a non-recourse capital stack using debt up to 95% or more of an investment's value, with debt service coverage ratios less than 1:1 for as long as three years at a blended interest rate in the neighborhood of 6%, interest-only for up to 10 years. By the fourth quarter of 2007, the norm was more like a recourse loan at 65-75% LTV, with DSCR of 1.2:1, interest rates well above 6% and a 30 year amortization schedule—much like what mortgages looked like before Wall Street figured out how to securitize loan pools and sell off the tranches to investors around the world.

Consider also: Commercial Mortgage Backed Securities ("CMBS") issuance in 2006 was $202 billion[1] and $230 billion in 2007. That equates to substantial fees and a significant number of jobs along with a considerable investment in technology and infrastructure on Wall Street, at hedge funds and in commercial banks around the world. Even though estimates suggests CMBS issuance might fall by half or more in 2008[2], getting out of the business is probably not a serious consideration for industry players.[3] In other words, some form of securitized real estate lending is now part of the permanent financial landscape, which means the capital markets, over time, will continue to play a dominant role versus traditional bank lending.

author

Rob Hellman, AB '76, is a Managing Director at The Ackman-Ziff Real Estate Group LLC in New York; he was assisted in the research for this article by Jake Lamstein, an analyst at the same firm. Rob also is a member of the Cornell Program in Real Estate Advisory Board and a member of the Cornell University Council.

Jake Lamstein assisted in the research for this article during his internship at Ackman-Ziff.



1 Commercial Mortgage Alert: CMBS Market Statistics, January 18, 2008.

2 Commercial Mortgage Securities Association (CMSA) Investor Conference, January 2008

3 On January 15, 2008, The Wall Street Journal ran an article from the February 2008 issue of Harper's Magazine suggesting that global capital markets would have to create another asset investment bubble after the housing market collapsed in order to earn enough fees and returns to pay for losses suffered previously.

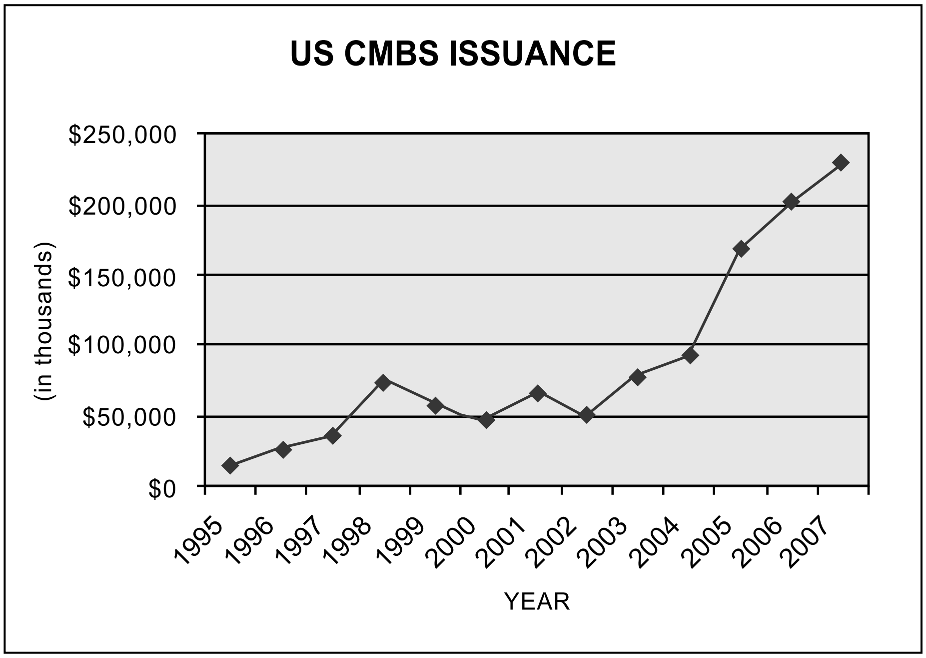


figure 1

US CMBS Issuance

Liquidity vs. Risk

A key component to the surge in real estate values over the last several years is the level and composition of liquidity directed toward the asset class. On a relative basis, such surges are generally caused by too much money chasing too few assets, and end when investors discover, usually harshly, that there is a surplus of (quality) assets (relative to the capital). Contemporary investing patterns have added characteristics like securitization and international capital flows to real estate. These conditions never really existed before in the realm of "hard" assets, having existed primarily in financial, or so-called liquid, assets (stocks and bonds).

Beginning in the late 1980s, bankers and traders on Wall Street figured out how to bundle residential mortgage loans together and turn them into bonds with varying tranches of risk pools that institutional investors would be willing to buy and sell.[4] Soon after, in the wake of the Savings & Loan disaster and creation of the Resolution Trust Corporation, the really smart folks on Wall Street figured out how to do the same for commercial mortgage loans.[5] The real key to selling bonds to institutional investors (i.e. pension funds, insurance companies, corporate treasury departments) is making it easy to assess risk levels on very large transactions. It's not too difficult to assess the risk that a loan on a single asset will be repaid (banks do that every day), but it is extremely difficult, time consuming and expensive to assess the risk that a large portfolio of mortgage loans will be repaid on time and in full. The short-cut is to get a reputable third party to do the work and characterize the risk for you, which can then be priced relative to other assets. Enter the ratings agencies—Moody's, S&P, Fitch.

The ratings agencies provide a pivotal link in promoting worldwide liquidity by allowing investors to determine how much risk they want to accept and what to pay for it. In the world

4 Default rates and average life of residential mortgages had been tracked for a number of years, thus allowing for reasonably straightforward assumptions regarding risk.

5 Unlike residential mortgages, holding periods and default risk for commercial mortgages were far more variable, which meant greater scrutiny had to be given to the borrower, the asset and general market conditions. Default protection ultimately was provided by the growth of "first-loss" investors who were willing to forego current interest in exchange for equity-like returns they would receive either when all other investors were paid in full or individual assets went into default and allowed these investors to foreclose and manage the assets to a point at which they could be sold for a profit.

of corporate credit-worthiness, generally speaking, an "A" rating on, say, IBM bonds and GM bonds means those bonds carry the same level of risk and therefore should cost about the same to purchase. In this world, a "AAA" rating should mean the risk of bond default is only slightly greater than the possibility the US government will default on its own bonds. So if a ten-year Treasury bond is yielding 4.0%, an investor might expect to be paid only 4.25% for a privately issued bond with a "AAA" rating because the risk of default is only marginally greater than that of the federal government.

In 2006 and 2007, about $612 billion from around the world had been used to buy commercial mortgage backed securities ("CMBS"), mostly in the form of rated bonds.[6] The interesting thing about CMBS bonds is that in some ways they are created and rated in a reverse fashion from the typical corporate bond. In the latter, the ratings agencies assess the stability of a company's business prospects to determine its risk of default; the company now knows what its credit rating is based on its business model and can determine the cost of selling bonds (i.e. the interest it will have to pay) to attract buyers. In the typical CMBS bond, the issuer works with the ratings agencies to determine the level of subordination (i.e. protection) each tranche of the bond will require to qualify for a certain rating and then slices up the cash flows from each mortgage to match the level of risk investors are willing to accept in order to purchase the bonds (which is somewhat of a synthetic process).

To create further liquidity, financial engineers had been busy structuring other investment vehicles, most prominently collateralized debt obligations (CDOs) and structured investment vehicles (SIVs). CDOs act like CMBS except that the former often use as collateral the riskiest levels of a real estate loan—the so-called "B pieces." By combining these loan pieces into a single bond with different risk tranches, one could create AAA-rated investments out of B-rated paper because the top slices would, presumably, be protected from default by the subordinated tranches. SIVs, on the other hand, are off-balance sheet entities created by banks to issue short term, low-interest debt in order to buy longer-term, higher-yielding securities such as CDOs and CMBS. Because CDO investors and SIVs were buying the riskiest tranches of real estate loans in the search for higher yield, they injected significant liquidity into the real estate lending market that in many ways acted as the grease to the CMBS and CDO market wheels.

The question then becomes is an A-rated CMBS tranche equally as safe as an A-rated IBM bond. In theory, yes. But because the bonds are created differently, is this always true? Historically, CMBS issues have had a significantly lower rate of default than corporate bonds. What the ratings agencies have noted, however, is that CMBS bond prices may exhibit a higher degree of volatility, thus impacting secondary market trades more quickly and severely than in the corporate market. Unfortunately, this directly impacts the ability of issuers to appropriately price new issues and write loans to fill new pools. This problem, perhaps more than any other, is at the base of what happened to the real estate credit markets in 2007. That is, beginning in the third quarter of 2007, CMBS investors lost confidence that the bonds they were buying were as risky or safe as their ratings implied; and confidence, more than anything else, drives the financial markets. Most prominently, this played out among some of the most experienced real estate companies, such as REITs, who insisted that they had seen no change in the fundamental health of their assets, but had suddenly been cut off from their cheapest sources of capital, thus displaying the dark side of CMBS issuance: to make the bonds work and drive the volume of loans (the liquidity) necessary to support the industry, great loans are mixed in with sub-par loans, [7] and it's the latter that have everyone concerned.

In a perhaps belated recognition of inherent flaws in the system for assigning risk levels to structured real estate debt, the ratings agencies have suggested creating a new rating regime for CMBS and related issues, which might include older issues as well as new issues of bonds. While this might ultimately resolve the questions that recently have been raised, it would seem that the short term effect could be to create significant confusion in the market and constrain the ability of institutional buyers to quickly restore liquidity.

---

6 Commercial Mortgage Alert: CMBS Market Statistics, January 18, 2008.

7 National Real Estate Investor, "Sounding the Alarm Bell on CMBS Lending," June 2005.

Perhaps the most intriguing issue raised by the seizing up of the real estate capital markets is that CMBS and CDOs were supposed to overcome the inherent risk in real estate by spreading the risk so widely that no single investor would be harmed in the event of a default.[8] Unfortunately, the markets aren't perfect and many of the loans being financed in this manner were being underwritten to perfection (i.e. with no margin for error), but lenders, eager for volume to keep the machine running, began accepting less stringent underwriting in issuing new loans. Furthermore, buyers, hungry for higher yield in fixed income products like CDOs, were using increasingly significant levels of debt to leverage their investments in these products. When a nominally small number of defaults began to occur the impact on holdings was magnified due to the leverage, which in turn eventually called into question the value of the entire asset class. Buyers put the breaks on until there were no bid/asks, which led to a further drop in prices. So, while in theory the structure should have reduced risk, human nature (i.e. greed) was the one component that could not be adequately underwritten. Could CDOs make a comeback? The structure itself is not flawed, so one would think so; but if their reputation has become toxic, there will be little appetite and no market for the product.

Once such underwriting was accepted, and due in large part to competitive pressures, it also became easier to offer more liberal loan terms such as interest only payments, interest reserves to cover initial periods when cash-flow could not cover debt service (on the belief that future cash flows would enable a sale of the property sufficient to pay off the debt), relaxed requirements for capital expenditures and a reduction in lender safeguards such as the use of lockboxes to capture property rents. In addition, "subordination levels in the bond ratings…decreased, providing less credit support for investors in the senior tranches" (from 33% in 1995 to 12% in 2007).[9] However, buyers of the bonds, relying on ratings and structure, demanded no additional risk premium for the change in underwriting. When the ratings agencies finally began raising red flags over some of the larger loans, the combination of that plus the concurrent crisis in sub-prime mortgages and residential mortgage backed securities ("RMBS") created a crisis of confidence among investors.

"What really made the wheels come off the system, however, was the use of leverage."

This crisis of confidence left many borrowers shell-shocked as the liquidity pipeline shut down almost overnight, even though defaults on commercial real estate loans were still near historic lows[10] and most fundamentals continued to look solid. Investors, however, were afraid they were beginning to see the start of a trend when it was noted that defaults on CMBS loans issued in 2006 were twice the level of defaults on CMBS loans issued in 2003.[11] Considering the mess residential mortgages were in, it's not surprising to see spill-over into the commercial market, even if it meant leaving good projects unfunded. Although CMBS loan delinquencies continue at or near historical lows, the real concern remains over loan quality for debt issued at the top of the market when underwriting standards had diminished.[12] The great unknown is whether such loans can be refinanced or paid off through asset sales.

What really made the wheels come off the system, however, was the use of leverage. Much like the Long-Term Capital Management crisis in 1998, investments in a relatively small part of the capital markets had a disproportionate impact on the larger market because leverage magnifies both successes and failures.[13] Most prominently, CDOs and SIVs use extremely high levels of

---

8 Unlike portfolio, or on-book, lenders such as banks and insurance companies that make real estate loans and hold the risk on their balance sheets, CMBS issuers immediately sell to third-party investors their exposure to the loans by selling the loans in pieces, or tranches, with varying levels of risk of repayment. The risk of owning the slices is mitigated by the fact that no single loan default could cause much damage. In the residential market, the safety factor was the assumption that home prices would never fall nationally—an assumption that proved untrue and had much to do with the sub-prime mortgage meltdown. And, when the initial underwriting of the underlying assets became suspect, the confidence in the fundamental value of the bonds evaporated quickly.

9 Goldman Sachs & Company, "Review of Commercial Real Estate Loan Market", February 2008.

10 Fitch Ratings press release, November 28, 2007.

11 National Property Investor, September 1, 2007.

12 Compendium of Statistics, Commercial Mortgage Securities Association, January 18, 2008.

13 In 1998, a single fund, Long-Term Capital Management, nearly brought global capital markets to a halt as commercial and investment banks stood to lose their entire investments after the fund leveraged the equity by

leverage in order to generate the returns their investors require from the assets being purchased. A relatively small impairment of value in the underlying bonds has an adverse impact on the equity invested of several times the impairment, causing investors to rapidly pull back from the sector. This is what happened in 2007 when investors suddenly rediscovered risk in real estate.

Quality Rules

It may sound axiomatic, but by the end of 2007 only the most qualified borrowers and soundest properties or developments were getting funded via commercial banks or CMBS conduits. In other words, if you had no experience, no real liquidity or no reasonable business plan, there was little chance capital was available from any lender other than so-called "hard money lenders" who were making 50% LTV loans at 12% plus 4 points. This is less obvious than it sounds since the CMBS market had grown so big, so fast that quantity mattered more than quality in order to keep the machine running—clearly an explanation for the explosion of sub-prime mortgages in the residential market or developers who suddenly qualified for hotel loans regardless of whether or not they understood the hospitality business?

Over the last decade, the market moved to securitized lenders because they offered higher LTVs, speedier execution and non-recourse loans. At the end of 2007 and into 2008, many securitized lenders could not guarantee quotes or proceeds, especially for larger deals, mainly because they couldn't sell bonds and were therefore having difficulty pricing their loans accordingly. As a result of the new reality, at the end of 2007 banks and insurance companies, with more stable sources of capital, but different investment goals, were competing more effectively against conduits and other securitized lenders. And the primary advantage such lenders currently have is certainty of execution because funding does not depend on third-party investors' willingness to buy the debt.

> "Conservative lending standards mean lenders want sponsors, investors, developers to actually have their own skin in the game, or at least cash from investment structures for which they are responsible."

So on-book, or portfolio, lenders filled much of the lending gap, while applying their normal standards, which include lower LTVs and higher quality borrowers. Typical transactions require 30% equity and debt service coverage has to be positive throughout the life of the loan. Such lenders have to be more conservative because they continue to bear the risk a loan will default, unlike issuers of CMBS who off-load the risk to investors around the world. In addition, portfolio lenders such as insurance companies invest capital in real estate both for their own profit and to create a set of returns to match their future liabilities (insurance claims or pension payouts, for example).

Portfolio lenders also have capital allocation limits that are far different from CMBS issuers, which seemed able to access a never-ending supply of capital (ironically, often from the same portfolio lenders who also lend direct but were also buyers of rated CMBS debt). Such lenders have to balance their investment profiles over time so as not to be over-exposed in any one segment such as retail or office product. Ironically, as fiduciaries they are very good at balancing risk and return which, in the current environment, has led them to purchase triple-A CMBS bonds in the secondary market at discounted prices as other investors sell off their holdings. As a result, certain sectors of the real estate industry may become relatively more difficult to finance as portfolio lenders limit their exposure to property categories that become over-heated.

True Equity Is Back In Style

Conservative lending standards mean lenders want sponsors, investors, developers to actually have their own skin in the game, or at least cash from investment structures for which they are responsible. Nominally, this means 25-35% equity (and often does not include improved or inflated land values), i.e., to the lender it must look like real cash in the deal. So developers can use all of their own cash or they can take on partners in the form of mezzanine debt/preferred equity

---

up to 30x, and the investment model failed to perform as predicted. The model assumed an unlimited access to low-cost debt; when losses began occurring as the cost of debt rose, LTCM's equity investors had a crisis of confidence and began withdrawing their equity, thus choking off the fund's ability to maintain its positions on over $1 trillion worth of derivative investments.

and maybe bring the "equity" to 80-85% of the amount required. Above that, mezzanine debt is either non-existent or extremely expensive. Third-party equity is almost always expensive, but it is a very real alternative to consider. However, like portfolio lenders, third-party equity sources also became more focused on fundamental underwriting criteria and developer experience.

As a result of the increased equity requirement, and other more stringent lending standards, loan amounts to borrowers have necessarily decreased as well, making acquisitions and refinancings more difficult to achieve. What looked good in July of 2007 became a nightmare by February of 2008 as illustrated below:

Review of Commercial Real Estate Loan Market [14]

	Jul 07	Feb 08
Asset Value	$25,000,000	$25,000,000
NOI	$1,509,150	$1,509,150
CapEx/Reserves	$120,000	$120,000
Net Cash Flow	$1,389,150	$1,389,150
Swaps Rate	5.66%	4.33%
Spread	0.96%	3.30%
Rate	6.62%	7.63%
Amortization	0	30 yrs.
Loan Constant	6.62%	8.50%
Min. DSCR	1.05x	1.15x
Proceeds	**$20,000,000**	**$14,215,179**
LTV	**80.00%**	**56.86%**

table 1

Review of Commercial Real Estate Loan Market

A corollary: Recourse lending is back as well. Investors and developers have to expect full or partial recourse provisions in loans for the foreseeable future. It's not that non-recourse has completely disappeared, but it will be more of the exception than the rule. Recourse lending serves to better protect lenders but it also governs borrowers' ability to take on projects beyond their competency. Where recourse is concerned, the borrower must not only show adequate net worth, but must have considerable liquidity as well. There are ways, however, to burn down the recourse based, for example, on an increase in NOI and free cash flow—i.e., as the value of a property increases based on property fundamentals (versus cap rate compression or some exceedingly aggressive rental growth assumptions), lenders might show some flexibility on this issue.

Another key market constraint is the fact that construction lending is extremely limited. Typically issued as floating-rate debt, and mostly the province of local banks for smaller projects, large construction loans have long been favored by European banks due to their size and capital bases. They were also among the primary investors in SIVs and buyers of CDOs, and much of this floating rate debt was converted in CMBS issuance. The overall flight to quality in the capital markets drew investors away from riskier investments such as SIVs and CDOs, taking with them the floating-rate CMBS market. This also caused construction lenders to pull back on making

14 Goldman Sachs & Company, "Review of Commercial Real Estate Loan Market", February 2008.

large loans (over $100 million) in order to limit exposure and the risk they might not be able to syndicate pieces of the loans post-closing. So-called "club deals" (i.e., pre-closing syndicates) thus became increasingly common. Of course, those kinds of deals are harder to craft. Without a market into which lenders can sell these loans, availability is highly uncertain. Now, when development loans are getting done, proceeds are usually in the 60-70% loan-to-cost range rather than the 70-80% loan-to-value range (which could often equal 100% LTC).

A still unanswered question is whether sellers of commercial real estate will adjust to the new lending environment by moderating their pricing expectations (i.e. if capitalization rates rise as financing becomes more expensive). Priced to perfection, an investment bought at a cap rate far lower than the lending rate makes sense if rental growth far exceeds the cost of the debt. If growth slows, or debt becomes far more expensive in the future, the likelihood that such a property can be sold or refinanced to pay off the lender becomes suspect. As a matter of reference, a recent survey conducted by PriceWaterhouseCoopers indicated that cap rates are expected to rise 25 to 50 basis points, in 2008, across the board.[15] While repricing is critical to increasing transaction volume, as 2008 progressed, the uncertainty in the financial, and broader, markets led investors to refrain from buying all but a small number of the most highly regarded assets, <u>regardless of price</u>. And, with the price of bonds backed by commercial mortgages being driven down to record lows, some lenders chose to ignore the property market and put their money to work buying seasoned secondary CMBS issues.

The $64,000 question, of course, is when does lending return to "normal?" Arguably, we have already returned to normal in the sense that the aggressive lending practices over the last four years have been an anomaly leading to a cleansing credit crunch, although it's just as reasonable to consider the recent credit crunch an overreaction to questionable lending standards. The CMBS market is not going away, though it will shrink, at least over the next year. Once the market has determined that all of the questionable loans have been identified and priced appropriately in the secondary market, new issuance is likely to increase sharply. As this occurs, especially in fixed-rate lending, one should expect lending standards to more closely track those of portfolio lenders —i.e. a greater equity component, positive debt service coverage and assets with recognizable upside potential.

Net-net, securitized mortgage debt is a positive development in commercial real estate finance. Issued and rated properly, it injects tremendous amounts of fresh capital into the real estate industry and allows a great many investors a way to diversify their portfolios. A return to quality is good for lenders and for experienced developers who understand the fundamentals of the real estate industry. Despite its periodic excesses, a liquid market for capital opens opportunities for developers and investors alike. Moving back to basics in 2007 and 2008 will no doubt prove to be a long-term advantage for the industry as a whole.

---

15 <u>Emerging Trends in Real Estate 2008</u>: Published by Urban Land Institute and PriceWaterhouseCoopers.