

**"Commercial Real Estate Financing in a
Post-Securitized Lending Era"**

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(2010 PLI)

Two years ago, real estate securitized lending came to a crashing halt amid concerns over bond ratings for CMBS and CDO issues, asset valuations and the oversized impact very high leverage had when lenders borrowed short and lent long. Real estate developers and investors learned the hard way that the liquidity securitized lending added to the real estate industry put them more at the mercy of financial markets than ever before. Because such markets rely on investor confidence as much as, or more than, NOIs and an “expert’s” projections, capital can flow out a whole lot faster than it flows in. Without a readily available alternative, liquidity drained from real estate before most investors were able to cash in their chips, creating huge paper losses and shutting down the market efficiency that had propelled real estate to the top of the investment pyramid.

For a while, it appeared that real estate had become a truly liquid asset, despite its bricks-and-mortar status, able to trade on more than just the underlying fundamentals. With spreads for the AAA CMBS tranches only minimally above the risk free Treasury rate, many investors seemed to believe either that real estate required little in the way of a risk premium or that Wall Street had rung out virtually all of the risk through financial engineering. Unfortunately, neither of these options proved to be true. With the broad-based economic decline brought on by a lack of credit beginning in 2008, real estate began showing its true colors as employment dropped, offices emptied, stores went dark and real estate valuations fell as a direct consequence of declines in net operating income and a gradual return to historic norms for capitalization rates.

By the end of 2007, certain trends in real estate lending appeared likely, most of which can be seen today, and are useful to examine as a means to gauge where real estate financing stands at the end of 2009. The good news, then as now, is that “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.”¹

The essential question is whether the commercial real estate industry can thrive without a vibrant securitized loan market? Or, are we headed back to an environment in which commercial banks and insurance companies dominate the lending landscape? The answer to both propositions seems to be “no”, but the short-term future looks significantly different than the immediate past.

Diminished Capacity. Consider the fact that Commercial Mortgage Backed Securities (“CMBS”) issuance in 2006 was \$203 billion, \$230 billion in 2007, \$10 billion in 2008², and perhaps only \$5 billion in 2009. Consider also that insurance industry lending has remained fairly stable at around \$45 billion annually (though approximately half of that is reserved for existing borrowers) and commercial bank lending for commercial real estate in a good year has about equaled the insurance industry’s numbers, but has been almost non-existent since mid-2008. Finally, consider the fact that many of the commercial real estate loans written in the last five years have fairly short term maturities and the refinance exposure runs into the trillions of dollars.

Common expectations for near term commercial lending include no change from the insurance industry, little change from commercial banks as they continue to work through their own capital issues and eventually a return of the CMBS market, but with estimates of the size of that market ranging only from \$45 billion to \$85 billion annually. In other words, the core US commercial real estate lending environment that exceeded \$300 billion in 2007 might return to half that amount by 2011. And, as it does return, loan terms will look far more conservative than those to which developers and investors became accustomed, meaning greater spreads on debt, lower loan-to-value requirements and greater (unleveraged) equity contributions from sponsors.

¹ Hellman, Robert, "A Snapshot of Commercial Real Estate Financing in Late 2007: Back to the Basics." Practising Law Institute, 2008.

² Commercial Mortgage Alert. 2009.

“Risk” once again is a four letter word. Despite the devastation securitized lending caused since 2007 (sub-prime residential loans, commercial real estate loans, auto loans, student loans and just about any other ABS loans you can think of), it is perhaps one of the greatest advances to benefit the real estate industry. Unfortunately, it went from a credit business to a fee generation business, requiring ever larger volumes to feed demand generated worldwide for the slightest bit of premium over so-called risk-free loans (e.g. US Treasury bonds). In the low-interest rate environment created by central banks trying to avoid a deep recession after the tech bubble burst, highly rated paper across the debt spectrum generated razor thin spreads over indexes like LIBOR or Treasury bonds, further compressing yields on even the lowest rated tranches of CMBS bonds. Somewhere along the continuum beginning around 1995, when commercial real estate CMBS became a proven product, and ending in 2007, lenders (i.e. investors) seemed to come to believe that the risks inherent in commercial real estate had been sufficiently identified that not only could that risk be tranching out, but that in doing so the overall risk had somehow been mitigated as well. And because issuers of real estate debt were able to sell off all of their risk, if they so chose, risk further receded from consideration when creating large pools of real estate loans for securitization.

Borrowers, too, had discovered a market so hungry for yield that they were able to sell off substantially all of their risk as well. A key component to the inflation of real estate values was the ability of developers to raise third-party (or leveraged) equity at historically low cost by layering into the capital stack increasingly complex mezzanine debt or preferred equity in order to acquire or build new projects. While equity returns of 15% or more on real estate projects had historically been considered an adequate risk-adjusted return, nominal (unleveraged) mezzanine debt or preferred equity returns began falling below 10% as the bull market for real estate continued. When the capital markets shut down, the economy faltered and developers could no longer refinance at will, investors suddenly realized that they were no longer being compensated appropriately for the level of risk they had accepted. At that point, yields on AAA CMBS tranches

skyrocketed to as much as 18% and most of the remaining tranches lost all interest from potential buyers. Currently, yields have eased as the risk has been reassessed, but double-digit returns on (supposedly) near-risk-free debt is still not unusual.

Revenge of the Underwriters. Conventional wisdom at the beginning of 2008 was that only “good” deals could still get financed (implying, of course, that “bad” deals were able to be financed previously). And, for a time, that was mostly true, as commercial banks continued to lend, but conservative underwriting suddenly seemed prudent. But prudent, market-driven lending changed all the assumptions borrowers took for granted when the market was flush, as noted in the example below:

	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%

Furthermore, “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

³ Goldman Sachs & Company, “Review of Commercial Real Estate Loan Market”, February 2008.

lenders.”⁴ What was true in February, 2008, remained more or less true through 2009, and is likely to continue throughout 2010, though perhaps for different reasons. Obviously, the above example applies to refinancing as well as new loans, forcing many owners to consider foreclosure or some kind of recapitalization.

As the residential mortgage market continued to deteriorate, so too did the economy and with it the commercial real estate market. CMBS issuance essentially disappeared, which dried up demand for conduit loans, while commercial banks’ balance sheets crumbled, loan reserves had to increase and capital for lending disappeared. As a result, capitalization rates increased toward the historic mean of around 8-9%⁵, so property values declined, increasing, at least on paper, bank losses, which further depressed the ability of lenders to finance real estate transactions. As a result, the market has moved back to benefit cash buyers or those with substantial enough resources to accept low-leveraged mortgage loans in the 60-70% LTV range. The one exception to this is the multi-family market where the GSEs, Fannie Mae and Freddie Mac, continue to lend at proceeds of 80-85% in order to support the housing market. Even there, however, the amount of true equity (i.e. sponsor equity) that is required prevents developers from borrowing the majority of the equity required to fund an acquisition or development.

After all this, and assuming one can find a lender willing to finance the real estate, borrowers have been re-introduced to the concept of recourse debt. Securitized lending became so attractive, even with the constraints imposed by the REMIC (real estate mortgage investment conduit) rules, in large part because lenders were able to offer non-recourse loans to many developers who could not access such funding from their local banks (apparently, with good reason as it turns out). While a developer today may have access to “good” deals, place enough recourse debt on the

⁴ Hellman, Robert, "A Snapshot of Commercial Real Estate Financing in Late 2007: Back to the Basics." Practising Law Institute, 2008.

⁵ Emerging Trends in Real Estate 2008: Published by Urban Land Institute and PriceWaterhouseCoopers.

developer's balance sheet and the ability to access financing becomes difficult, if not impossible.

War Games. In the 1983 movie, "War Games," Matthew Broderick's character learned the concept of mutually assured destruction. While the movie was a fanciful look at nuclear warfare (oxymoronic as that might sound), ultimately it was a game that no one could win; and history students will recognize the result as a cold war that lasted for decades. In some ways, Broderick's lesson looks familiar to the commercial real estate finance industry – banks could launch the foreclosure missile, or borrowers could toss back the keys, but only at the expense of banks' balance sheets, which might lead to additional bank failures and even less hope for lending in the future – and a possible economic melt-down.

Whether or not one agrees with this assessment, there is no doubt that the federal government is trying just about any way it can to give banks enough breathing room to avoid recognizing losses on their balance sheets that would further erode their capital positions. During 2009, at the urging of Treasury, the Financial Accounting Standards Board (FASB) came out with FAS 157-e modifying guidelines that would normally require banks to mark to market a sizeable portion of their real estate loans and keep those loans on their books at full valuations.⁶ Also during the year, the FDIC issued new guidelines giving banks the ability to categorize a loan as performing as long as debt service was current, even if the borrower was in danger of defaulting due to an imminent maturity default for not being able to sell or refinance the loan.⁷ The IRS also issued REMIC guidelines that will allow special servicers to enter into loan modification discussions prior to an actual event of default, without jeopardizing the tax-free status enjoyed by CMBS securities.⁸

⁶ http://www.fasb.org/fasb_staff_positions/prop_fsp_fas157-e.pdf

⁷ <http://www.fdic.gov/news/news/financial/2009/fil09062a1.pdf>

⁸ Rev. Proc. 2009-45.

Hope on the Horizon. Despite all of the bad news the industry has endured, as 2009 drew to a close there were glints of hope and thawing in the capital markets. Developers Diversified Realty (DDR-NYSE) issued CMBS bonds totaling \$400 million (Goldman Sachs underwriter), which were sold, in part, to buyers accessing the federal government's Term Asset-Backed Securities Loan Lending Facility (TALF). Shortly thereafter, Fortress Investment Management (FIG-NYSE) came to market with a CMBS issuance totaling \$460 million (Bank of America underwriter) with no TALF support. At the time of this writing, Inland Western Retail REIT was preparing to price a \$500 million CMBS issuance (JPMorgan Chase underwriter), also with no TALF support.

It is critical to note that these bonds are backed by conservatively underwritten collateral at low-to-moderate LTVs. But it also was clear evidence that investors' appetites for securitized real estate debt had returned if the pricing and underwriting properly accounted for the risk. It further proved that securitized lending in and of itself was not the bad guy in the horror movie playing since 2007. There is clearly a role for securitized real estate lending going forward – because it is also clear that banks and other lenders are less and less willing to hold real estate loans on their balance sheets and endure the risk of another systemic devaluation.