

Commercial Mortgage Backed Securities (CMBS) lenders accounted for more than \$225 billion of commercial real estate loans in 2007. With the fall-out of the secondary mortgage market, this same group lent only \$12 billion in 2008 (according to the February 2009 edition of Shopping Centers). It is very likely that most of the CMBS lending done in 2008 occurred early in the year with forward commitments dating back to 2007). In the



recent years past, these CMBS lenders accounted for approximately 50% of commercial real estate lending worldwide. This same group is completely inactive at the present time. Some experienced commercial mortgage brokers believe that these lenders may not return until 2010 or beyond (if ever). If they do return, their guidelines will be different and their percentage of the overall loan volume is expected to be much lower. The absence of CMBS lenders creates a void which banks and life insurance companies do not have the capital to fill, even in the best of financial times. This has reduced the amount of debt available in the market (and will do so for the foreseeable future). It is also resulting in stricter underwriting for new commercial loans from the remaining lenders (life insurance companies and banks).

With CMBS lenders gone and reduced available debt capital in the market, the remaining lenders can demand better spreads on interest rates and safer (more restrictive) loan terms. However, even with better spreads on interest rates and more restrictive loan terms, banks and life insurance companies face other restraints on lending going forward.

Banks

Banks have federally mandated limits as to the amount of money they can lend relative to their capital. Many banks are at these limits in aggregate or at least with respect to certain asset classes (i.e. land). This is especially true in growing areas such as Northern Colorado. Some banks are well over these limits and can not get non-performing loans off of their books. Banks are also finding that their ability to lend is constrained due to increased regulatory scrutiny and the inability of some existing borrowers to pay back their loans which, in better economic times would be paid off and that money could be redeployed into new loans. Therefore, in some instances, new good loans can not be made because of the bad loans already on the books. Banks may also have liquidity issues due to the loss in value of some of their other investments. To the extent that banks are not constrained by inadequate capital or lending limits, many are being cautious and choosing to invest their capital in areas other than new loans. Alternatively, some are holding their loan capital for existing long-term customers.

From talking to several lenders, banks understandably are placing a much greater emphasis on borrower credit than in years past. According to a recent update from Essex / Q10, a prominent commercial mortgage brokerage, *"net worth and liquidity requirements have increased substantially over the past year to an average of 200% and 20% of the loan amount respectively."*

Banks remain the primary construction lenders and some may engage in mini-perm floating or fixed rate financing of five years or less. Those with money to lend are quoting interest rates that are generally less than those quoted by insurance companies for ten year terms.

Life Insurance Companies

Life insurance companies can be an attractive financing alternative for borrowers looking for fixed-rate, non-recourse financing on loan terms of greater than 5 years. That being said, life insurance companies are now faced with the dilemma of how to allocate their funds. They can invest in instruments such as A-rated corp. bonds at around 8% or choose to lend money on commercial loans which may offer collateral and diversity but, in many cases more credit risk. According to Essex / Q10, the life insurance companies' *"funds for commercial mortgage investment are anticipated to be lowered 25-50% compared to historical averages over the past 3 years."*

The strong payouts in the bond market are causing the interest rates that the life companies offer to rise and stricter underwriting (more borrower equity, higher debt coverage ratios, higher proforma vacancy and other reductions against NOI that the lender may factor into their analysis). Essex also notes that *"maximum LTV will be 65% of "internal" value. Internal cap rates will generally be underwritten 50-100 basis points higher than what the appraisal will support."*

Property Valuations

In addition to lenders requiring more equity, valuations of properties are decreasing. Because of the lower tenant and buyer demand, appraisers are being very conservative as market conditions have changed. Brian A. Lee recently wrote in the January 2009 edition of Western Real Estate Business that *"seemingly overnight, low cap rates of 6 to 7.5 percent evaporated, strong tenant demand softened, new construction halted, financing moved away and the market overall underwent a major paradigm shift.... Appropriate cap rates in the 8 to 11 percent range are now available..."* There is no denying that capitalization rates have moved up significantly. There is an even greater effect on valuations when market lease rates are factored in on vacant space or short-term leases.

Financing Guidelines

Here are examples of the types of loans that should be able to successfully obtain financing:

- ▶ **New Development Projects:** These projects will require significant pre-leasing, good borrower credit, good tenant credit, a strong debt coverage ratio of 1.20 to 1.40+, and 35% to 40%+ equity.
- ▶ **Existing Buildings:** Those with a stable history of cash flow, a higher percentage of long-term leases (greater than the term of the loan), and reasonable debt coverage and loan to value ratios will be able to obtain financing. Properties with significant vacancy or short-term leases will require significant equity and a financially strong borrower.
- ▶ **Multi-family:** FNMA and Freddie Mac have been very active lenders. Interest rates and terms remain borrower friendly on multi-family projects where the rent levels can justify the cost of new construction.

Positioning Yourself for New Financing

1. If you are purchasing a property, be careful about how financing contingencies are structured in your purchase agreement. It is always a good idea to involve a competent real estate attorney in the drafting of such an agreement.
2. Be realistic about the state of the market, how lenders will underwrite your loan, and how much equity you will require.
3. Make it as easy as possible for the lender to understand your property and your financials so that they have what they need to approve your loan. Prepare a comprehensive package of information on your property, your tenants, and your personal financials. When asked to provide additional information, do so completely and promptly.
4. Before presenting your property to a lender, make sure to ask questions of them regarding the types of loans they are and are not engaging in. Focus on working with those lenders whose lending activities most closely align with your property.
5. Present your property to multiple lenders of different sizes and types (i.e. community banks, regional banks, large publically traded banks, and life insurance companies if appropriate). These institutions have varying financial circumstances and may have different perspectives, guidelines, and sources of capital.
6. Be willing to establish a depository relationship with the bank providing financing. They may require this anyway but, it would not hurt your chances of obtaining the loan if the bank knows up front that the relationship will extend beyond this one loan.
7. If you are uncertain as to which banks to contact, what information is important, or how to access life insurance companies or FNMA and Freddie Mac, seek the advice of an experienced mortgage broker. Chrisland Commercial can provide a recommendation for you if you would like.
8. Chrisland Commercial has expanded our line of services to include development and general real estate consulting in addition to brokerage and development. Do not hesitate to call if you have a real estate related need that we may be of service on. Our contact information is at the bottom of this page. You may also visit our website.

TARP: WHERE'S THE MONEY?



Former Treasury Secretary Henry Paulson

TARP funds have added needed capital to the larger banks (and companies like Goldman Sachs and Morgan Stanley who became bank holding companies) but because of tighter regulations and economic uncertainty, borrowers are still having difficulty getting new loans approved. Two

prominent local banks have estimated that borrowed TARP funds carry an effective interest rate of 9 - 10 percent for participating banks. This is at a level that may not facilitate new lending unless the participating banks have an ultra low alternative cost of funds, such as a lot of low interest checking deposits to blend it in with. Another reason that many local banks are not participating in TARP are some of the mandated provisions such as restrictions on dividends and ambiguous language relative to how the government can change the agreement at their discretion in the future. Therefore, those that have participated in TARP have generally been larger publically traded banks. A number of whom, have used that money to help finance acquisitions of other financial institutions.

ON A POSITIVE NOTE...



The world will learn from the mistakes of yesterday. True, it will take some time to work through some of the mistakes.

But, corrections are taking place in property valuations. This is a healthy part of the economic cycle as this will create buying opportunities. The sooner we get through this trough in the economic cycle, the sooner we will be on our way to a better economy. As for the time being, Mark Twain was quoted as saying:

"I am an old man and I have known many troubles but, most of them never happened."

Be smart, be diligent, and plan for tough times but, do not worry about the negative that might be because... it may never be.

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