PRIVATE DEBT

by Walter R. Huggins and Kurt L. Wright

How Low Will Spreads Go?

(Not to Mention Underwriting Standards?)

Twelve months ago potential borrowers were dragging their feet on new financings, anticipating a reduction in both Treasury rates — 10-year Treasury rates were 6.7 percent in June 1996 — and in spreads on high-quality mortgage loans, which at the time were averaging around 150 basis points over Treasuries. The strategy paid off, at least in part.

At mid-year 1996, traditional whole loan lenders were left wondering whether they would come close to meeting their investment allocation targets. At the same time, the Wall Street securitizers had begun to pose serious competition for the lower-quality institutional-grade loans. In response, certain traditional lenders may have overreacted by lowering spreads too far, too fast. While spreads ranged from 125 to 175 basis points over Treasuries, over the next six months the average deal moved from the middle toward the lower end of the range. In addition, lenders loosened underwriting standards further by increasing loan-to-value (LTV) ratios and lowering debt-service coverage (DSC) requirements on new loans on all property types. While still within prudent ranges, the combination of lower spreads and relaxed underwriting standards decreases the margin for error.

Have lenders gone too far? Only time will tell. On the one hand, as of the First Quarter of 1997, commercial mortgage delinquencies as reported by the American Council of Life Insurance stood at 1.63 percent, an all-time low. The good news on delinquencies — at a time when commercial real estate fundamentals generally are very strong and expected to remain so for a long time to come — gives comfort that margins for error are still quite acceptable.

Additionally, in a mixed-asset context, traditional mortgages still offer solid relative value; spreads on alternative comparable credit fixed-income products are considerably lower. For example, "BBB" rated corporate bonds currently trade at spreads of 75 basis points, while even "BBB" rated commercial mortgage-backed securities (CMBS) are at 95 basis points and lower. Spread compression on all CMBS credits, but particularly "BBB" and below, has shifted the relative value pendulum back in favor of traditional whole loans.

Another key consideration is the significant growth in liquidity for commercial whole loans caused by the explosion in CMBS new-issuance volume. With $30 billion of CMBS issued during 1996 and at least as much anticipated for this year, securitizers are sopping up as many whole loans as possible. Whereas 10 years ago, whole loan lenders had but one option — i.e., lend-and-hold — today anything is salable in a relatively short time frame. Thus, the liquidity premium required for prudent whole loan lending has decreased. It is unclear precisely how much of a decrease is justified. Nonetheless the trend is clear. If, in the pre-modern world of whole loan lending (say 1975 to 1990), spreads on high-quality whole loans averaged around 125 basis points, then arguably spreads today can drop below this level due to the increased liquidity in the whole loan market.

On the other hand, it can be argued that now is the time to get conservative, as we move toward the top of the real estate market cycle. In essence, mortgage allocations should be decreasing and quality lending emphasized. While at the national level real estate fundamentals have never looked as strong, at the more local level one must be cautious. Apartments in Atlanta, for example, are probably very close to the top of the cycle with retail not far behind. Industrials in several Southeast markets are

Figure 1 Commercial Mortgage Capital Sources

Lender Requirements*	2Q/96	2Q/97
Insurance Companies/Pension Funds ("A" Quality Real Estate)		
Rates	7.80–8.45%	7.65–8.15%
Spreads (UST)	125–175 bp	120–165 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.20x	1.20x
Term	7–10 yrs.	7–10 yrs.
Commercial Banks ("A" Quality Real Estate)		
Rates — Fixed	7.75–8.75%	7.50–8.00%
Rates — Floating	7.05–7.80%	7.00–8.25%
Spreads — Fixed (UST)	150–200 bp	100–150 bp
Spreads — Floating (LIBOR)	125–200 bp	100–225 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.15x–1.20x	1.15x–1.20x
Term	1–10 yrs.	1–7 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	8.75–9.45%	8.15–9.00%
Spreads (UST)	225–275 bp	175–250 bp
Max. Loan-to-Value	75%	80%
Min. Debt Service Coverage	1.20x	1.20x
Term	5–10 yrs.	5–10 yrs.
* Represents typical transactions, not full range.		

Source: Equitable Real Estate Investment Management, Inc.

both pricey and face a lot of competition. At the very least, we probably are closer to the top of the current real estate cycle than the bottom of the last one.

In addition to increased investor demand for loans, there are fewer good loans available than ever. This is due to the REIT market explosion and the steady growth of pension fund direct ownership of high-quality commercial real estate. REITs now control more than $120 billion of real estate, much of which comprises strong properties that previously would have been whole loan candidates at 75 percent LTV ratios. REITs generally are constrained by their shareholders to entity-level LTVs of 40 percent or so. In essence, they utilize less leverage than traditional private owners.

Furthermore, REITs are less and less apt to utilize traditional long-term financing, instead choosing the unsecured corporate debt route, which is far more flexible and much less expensive. A typical "BBB" rated REIT, such as Avalon Properties, Taubman Centers or Post Properties, today can borrow from banks on a floating-rate basis at 60 to 80 basis points over Libor. In addition to being cheap, this debt is flexible in terms of usage, pre-payment and documentation. This allows REIT executives freedom to focus on assembling and managing portfolios.

Additionally, pension funds have returned to the real estate equity markets and are seeking solid, long-term real estate plays, especially office properties. Pension funds, however, are generally averse to leverage. Thus, as we move further from a private, local market to a mature public/institutional market, more and more properties are removed from the reach of traditional lenders.

Ever-increasing demand for loans, especially from Wall Street, coupled with fewer high-quality properties available to lend on, can only result in lower spreads. But how low will they go? The CMBS market will drive this in large part. As more bond investors enter the CMBS market, new-issue execution risk diminishes and liquidity improves. Further, the marginal cost of securitization continues to fall as the support providers (lawyers, accountants, rating agencies, due diligence firms) gain sophistication. This drives down CMBS execution spreads, which allows for lower loan origination spreads. Traditional lenders must then lower their requirements in an effort to retain market share.

Arguably, as liquidity improves, CMBS spreads could compress to levels near those of corporate bonds. Some even have argued that spreads could be lower than corporate bonds given the superior control characteristics of a mortgage lien versus unsecured corporate debt. This would have a significant impact on whole loan pricing. For example, spreads on "AAA" rated CMBS at 65–70 basis points still are nearly double those of "AAA" corporates. The "AAA" tranches of any CMBS deal typically compose 65 percent or more of the overall deal structure. Thus, a material change in "AAA" spreads would have a material impact that ultimately would allow for lower spreads required at the individual whole loan level. Realistically, a 20 basis point decrease in overall weighted average CMBS execution spreads (i.e., from "AAA" through unrated tranches) is realistic over the next six to 12 months. As a result, it is both feasible and justifiable that whole loan spreads could fall another 10 to 20 basis points over this time frame.

Today, class "A" multifamily projects receive spreads of 105 to 120 basis points, with LTV ratios up to 80 percent and 30-year amortization. Quality industrials receive similar spreads with LTV ratios of 75 percent maximum and 25- to 30-year amortization periods.

Spreads on office (130 to 150 basis points) and hotels (175 to 200 basis points) have dropped over the past 12 months, with maximum LTV ratios having increased to 75 percent and 70 percent, respectively, in response to improving markets and the search for volume. Limited-service hotels still are an area of concern due to extensive new construction and therefore require an additional spread premium.

Retail spreads on power centers remain in the 140 to 160 basis point range, but spreads are in the 120 to 140 range for other retail types, at the 70–75 percent LTV range.

While we are comfortable about today's mortgage market, lending practices and the prospect of some continued spread tightening, one cause for concern looms. Some lenders are relaxing less visible terms such as reserve requirements for projected tenant improvements and leasing commissions, and some are limiting recourse provisions for environmental and "bad boy" provisions. As we approach the top of the real estate cycle, these are areas where lenders should be more diligent than ever. RECMR

Figure 2 Barron's/John B. Levy & Company National Mortgage Survey

	Second Quarter 1997	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	MAY 5	7.625%	7.875%	7.875%
	JUNE 2	7.750%	7.875%	7.875%
	JULY 7	7.250%	7.375%	7.375%
PRIME MORTGAGE RANGE	MAY 5	7.625–7.875%	7.875–8.000%	7.875–8.125%
	JUNE 2	7.750–8.000%	7.875–8.125%	8.000–8.125%
	JULY 7	7.250–7.500%	7.500–7.625%	7.500–7.625%
PRIME MORTGAGE RATE	MAY 5	7.750%	7.875%	8.000%
	JUNE 2	7.875%	8.000%	8.000%
	JULY 7	7.375%	7.500%	7.500%

(For loans $5 million and up)
Source: Barron's/John B. Levy & Company National Mortgage Survey; © 1997 Dow Jones & Co.

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