Borrowers Finding Plenty of Capital, Attractive Terms

Traditional Lenders Face Challenge from Wall Street Firms

by
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Originating mortgages on commercial and multifamily properties has grown intensely competitive over the past several months, a trend that should continue into the foreseeable future. Lenders regularly are sacrificing interest rates and other loan terms to make deals, while attempting to maintain quality underwriting standards. Generally, underwriting has remained within prudent levels, which partially is due to still recent memories of loans gone bad and partially due to the discipline instilled in the market by the rating agencies and regulators. For borrowers, these are wonderful times with reasonable levels of money available on terms that allow for very attractive positive leverage on many properties. Further, in an effort to stand out in a crowded field, lenders are working hard to differentiate their lending programs with features such as early rate locks, expedited closing procedures and mezzanine capital.

The staggering real estate capital shortage of the early 1990s today appears as a tiny dot in the rearview mirrors of market observers. Many lenders now are intent on maintaining and growing market share even as more — and more varied — participants join in. Most of the old competitors are back and slugging it out for their traditional lines of business. Life insurance companies, for example, aggressively are seeking fixed-rate loans on class "A" and "B" income-producing properties of all types. In addition, the commercial banks and savings banks are pursuing construction loans for apartments, offices, some retail, self-storage and manufactured housing. REITs also have become active in the build-to-suit market, using bank lines of credit to fund development. While currently under control, owners and lenders on existing properties should keep a close eye on this construction lending trend.

Traditional lenders are faced not only with tough competition from old, familiar adversaries, but also from a very formidable, relative newcomer — Wall Street. The investment banking firms and related conduits are only getting started and already have grabbed a large slice of the mortgage market pie. These lenders dominate the market for smaller, "B" and "C" quality assets and are competing hotly for very large high-quality assets. Furthermore, the securitizers are aggressively attempting to crack the market for medium-sized (i.e., $10 million to $30 million) high-quality loans that are now the domain of the life insurance companies and pension funds. Creative firms such as AMRESCO and Morgan Stanley Realty are confident that such loans can be made amenable to securitization and can be mass-produced in efficient conduit fashion.

While slightly ahead of its time, the notion that securitization can be expanded to the general market is now very plausible. First, spreads on commercial mortgage-backed securities (CMBS), particularly non-investment-grade CMBS, are falling rapidly. This tightening closes the required spread gap between securitizers and portfolio lenders, making the securitizers more competitive. Second, the rating agencies gradually are lowering their

Executive Summary

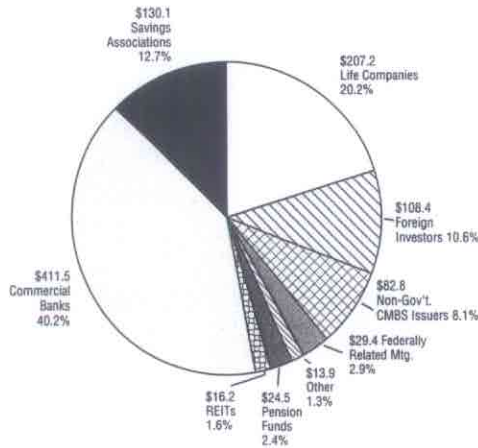
- **Competition among lenders continues to heat up, placing borrowers in an enviable position.**
- **Seven- to 10-year mortgages on high-quality properties are achieving rates typically ranging from 7.75–8.25 percent.**

Commercial Mortgage Capital Sources

Lender Requirements*	3Q/95	3Q/96
Insurance Companies/Pension Funds ("A" Quality Real Estate)		
Rates	7.25–7.75%	7.80–8.45%
Spreads (UST)	125–175 bp	125–175 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	7.25–8.00%	7.70–8.50%
Rates — Floating	7.25–8.00%	6.70–7.70%
Spreads — Fixed (UST)	150–200 bp	125–175 bp
Spreads — Floating (LIBOR)	125–200 bp	100–200 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.15x–1.20x	1.15x–1.20x
Term	1–10 yrs.	1–10 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	8.25–8.75%	8.75–9.45%
Spreads (UST)	225–275bp	200–275 bp
Max. Loan-to-Value	75%	75%
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.

Debt Real Estate Assets Held by Institutional Investors



Source: Equitable Real Estate Investment Management, Inc.

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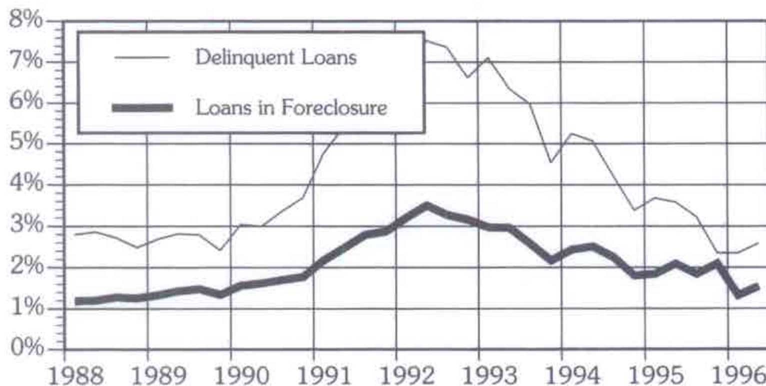
Mortgage Loan Delinquencies and Foreclosures



Source: American Council of Life Insurance

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

	Third Quarter 1996	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	JULY 1	7.875%	8.000%	8.125%
	AUGUST 5	7.500%	7.750%	7.875%
	SEPTEMBER 2	7.750%	8.000%	8.125%
PRIME MORTGAGE RANGE	JULY 1	8.000–8.125%	8.125–8.250%	8.250–8.375%
	AUGUST 5	7.750–7.875%	7.875–8.000%	8.000–8.250%
	SEPTEMBER 2	7.875–8.000%	8.000–8.125%	8.125–8.250%
PRIME MORTGAGE RATE	JULY 1	8.000%	8.125%	8.250%
	AUGUST 5	7.750%	7.875%	8.000%
	SEPTEMBER 2	8.000%	8.125%	8.250%

(For loans $5 million and up)
Source: John B. Levy & Company © 1996

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targeted subordination levels (supporting investment-grade tranches) for new CMBS offerings, which further reduces the cost of securitization. Finally, borrowers have moved up the learning curve and are more willing to accept certain onerous securitization parameters, such as reporting and lockbox requirements, if it means higher loan proceeds and longer amortization periods.

Ultimately, all of this demand for mortgage loans is great for borrowers and will someday lead to tremendous efficiencies in what until recently was a very private market. In the short run, however, the wide array of options facing borrowers has tended to confuse matters and slow transactions as borrowers have attempted to weigh their options. This confusion will get worse before it gets better. Several new players are poised to launch conduit operations in the near term. GE Capital, for example, is now entering the conduit market in its typical large fashion and can be expected to originate at least $750 million to $1 billion of new loans per year. Other weighty newcomers to the conduit lending market reportedly include ING Barings, Daiwa Securities and Deutsche Bank Capital Markets.

Despite these concerns, the market currently is performing very well. Delinquency and foreclosure rates as of the end of June were extremely low. As compiled by the American Council of Life Insurance, life insurers reported delinquencies of 2.60 percent, up 20 basis points from the First Quarter, but still near historical lows.

Spreads on quality properties have been fairly stable in the 125 to 175 basis points range for several quarters. The vast majority of loans on class "A" properties, however, are being made at spreads of 150 basis points and less. Today, this means that seven- to 10-year mortgages on high-quality properties are achieving rates typically ranging from 7.75 percent to 8.25 percent and occasionally as high as 8.50 percent. These rates are based on 75 percent loan-to-value (LTV) and 1.2x minimum debt-service coverage (DSC) ratios.

In terms of specific investor appetites, office properties are now in the spotlight for many lenders. Both CBD and suburban office projects are potentially attractive, although suburban properties still have a slight edge. Spreads on quality offices remain relatively high at 140 to 165 basis points. Lenders remain very concerned about the tenant rollover and are requiring escrows for near-term tenant improvements and leasing commissions.

Typical terms on office deals include 10-year maturity, 20- to 25-year amortization, 75 percent LTV ratios and a minimum of 1.25x DSC. When well-underwritten, office properties offer excellent opportunities today, as they still have a long way to go before reaching the top of their cycle.

Class "A" apartment loans are achieving LTV ratios of 75 percent at spreads of 125 to 130 basis points over.

Hotels are back, although lenders still are underwriting these conservatively with significant escrows for furniture, fixtures, and equipment and plenty of reserves in the cash flow. Since many lenders will not go past 70 percent LTV ratios, there is considerable opportunity in the market for mezzanine lenders who are willing to fund all or part of the 71 percent to 90 percent portion of the capital structure. Hotel cash flows are so strong today that there often is room to pay the mezzanine investor 15 percent and more on a current basis and still pay the first mortgage lender 150 to 200 basis points over Treasuries.

Retail properties require tremendous scrutiny today, and larger properties, especially regional malls, have become contrarian plays. The bottom of the cycle, however, seems to be in sight for most retailers and malls, and this may be a sector worth exploring for the brave of heart. Quality retail properties are achieving spreads of 130 to 175 basis points for loans with 75 percent LTV and 1.25x DSC ratios. At the same time, lenders are growing very cautious with power centers and have cut LTV ratios between 65 percent and 70 percent.

Lenders continue to hotly pursue apartment and industrial loans. Apartments are getting more scarce, and Fannie Mae is sourcing deals with 80 percent LTV ratios and spreads of 150 basis points for "B" quality properties. Class "A" apartment loans are achieving LTV ratios of 75 percent at spreads of 125 to 130 basis points over. Industrials remain the most difficult property type to source. Financing is widely available for quality properties with 75 percent LTV ratios and minimum 1.2x DSC at spreads of 125 to 150 basis points and a maximum of 30-year amortization. Spreads on certain individual industrial properties have fallen to as low as 120 basis points over. Both these property types generally are fully valued. Owners of quality apartment and industrial properties are in a great position today to achieve significant positive leverage on maximum loan proceeds. RECMR

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