by
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Equitable Real Estate

Increasing Lender Competition Tightens Spreads

Apartments Still Attracting the Most Interest

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1994 was a watershed year for the commercial mortgage industry. Not only did lenders return in droves to the traditional whole-loan market after the prolonged recession, but many new institutional lenders also entered the market for the first time. In addition, 1994 was notable for a widening acceptance of commercial mortgage-backed securities. In combination, these trends are extremely healthy for both investors and borrowers alike. The market will continue toward increased efficiency and liquidity as commercial mortgage-based products become more recognized by institutional investors as a legitimate asset class. This will further reduce the cost of funds for equity real estate owners.

This process will take time, however. Unfortunately, 1994 represents a significant lost opportunity for many borrowers with near-term refinancing needs. Ten-year Treasuries were yielding 5.75 percent at the beginning of 1994, while commercial mortgage spreads for quality properties were in the 150 to 225 basis point range. Thus, nominal rates were in the 7.25 percent to 8.10 percent range for commercial mortgages with 65 percent to 75 percent loan-to-value ("LTV") ratios and 1.25x minimum debt-service coverage ("DSC"). Currently, spreads on institutional-quality commercial mortgages have fallen to a range of 125 to 175 basis points over Treasuries; however, 10-year Treasuries are now yielding 7.80 percent. Therefore, nominal commercial mortgage rates are in the 9.05 percent to 9.55 percent range today, or 145 to 180 basis points higher than one year ago.

Given these higher nominal rates, borrowers today are less able to generate significant positive leverage, except at low LTV ratios. Since most loans carry heavy prepayment penalties and prohibitions against secondary financing, many borrowers do not aggressively seek low LTV loans. Further, at 9.50 percent borrowing rates, DSC is not always a "slam dunk" for 75 percent LTV deals with near-term tenant roll-over costs. As a result of this, new loan origination activity was disappointing in the Fourth Quarter of 1994. This is particularly true given the tremendous investor competition for deals.

Lenders have gone to great lengths to make attractive deals work for borrowers (although most have stayed well within prudent underwriting standards). Spreads moved downward steadily during 1994, while LTV ratios, DSC and amortization terms moved somewhat in favor of borrowers. On highly attractive deals, fees and closing costs have been sacrificed. Though lenders normally earn up-front fees of one percent or more from borrowers, some hot deals in hot markets have been made in the 25 to 50 basis point range. Additionally, on occasion, lenders have paid for certain closing costs normally borne by the borrower, particularly where the lender has in-house professional staffs such as legal, appraisal, environmental and engineering.

Undoubtedly, these trends will continue in 1995. Lenders who did not reach their allocation targets during 1994 will be all the more pressed to put money to work

Commercial Mortgage Capital Sources

Lender Requirements*	4Q/93	4Q/94
Insurance Companies ("A" Quality Real Estate)		
Rates	7.40-8.10%	9.10-9.75%
Spreads (UST)	1.90-2.35 bp	1.25-1.75 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	5.70-8.00%	8.75-9.80%
Floating	4.75-5.75%	8.75-9.50%
Spreads — Fixed (UST)	2.10-2.75 bp	1.50-2.00 bp
Floating (LIBOR)	1.75-2.25 bp	1.75-2.50 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.20x	1.15x-1.20x
Term	1-5 yrs.	1-10 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	8.10-9.25%	9.85-10.50%
Spreads (UST)	2.85-3.50 bp	2.10-2.75 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.25x	1.20x
Term	5-10 yrs.	5-10 yrs.

* Represents typical transactions, not full range.

Source: Equitable Real Estate Investment Management, Inc.

in commercial mortgages. Spreads will probably fall another 10 to 15 basis points or so by the Third Quarter and the range will compress to 115 to 160 basis points over Treasuries. Beyond this, there may not be much room for further movement. For the highest quality whole-loans, there is a natural floor for spreads of approximately 30 basis points above BBB-quality corporate bonds, which compensates investors for the illiquidity of the mortgage market. Since spreads will only fall modestly over the year, lenders will need to work hard in order to remain competitive.

Hopefully, this will take the form of competition on fees and expenses and, perhaps, enhanced loan proceeds supported by thorough due diligence. Lenders are cautioned that underwriting standards are currently at prudent levels and should not be pushed any further on most apartment, retail, industrial and many office properties. However, underwriting of some offices and most hotels is still too conservative and some relaxation here *is* warranted. For new lenders, the most critical aspect of competition is discretionary capital. Life insurance companies and conduits typically have discretionary lending programs and can commit quickly to deals. Discretion is very important to sophisticated borrowers who expect to be compensated for the perceived risks of nondiscretionary investment processes.

Apartment projects are still attracting the most competition. This is due to several factors, including a perception of strong fundamentals in many markets, the inflation-sensitive nature of apartment leases and their small size, which makes them appealing to a very wide array of lenders from the smallest life insurance companies to the largest state pension funds. FNMA and FHLMC also have aggressive lending targets, which ratchets down the entire multifamily spread structure from the highest to lowest quality deals. Overall, the apartment market offers many solid opportunities, but also arguably the lowest potential risk-adjusted returns of the various major property types. Spreads are relatively thin on apartments, LTV ratios are as high as 80 percent in some cases and valuations are often "full." In strong markets like Atlanta, permits for new apartment construction have increased dramatically and inexpensive single-family housing developments are mushrooming. Lenders need to proceed cautiously, especially with forward commitments on new construction. Given that,

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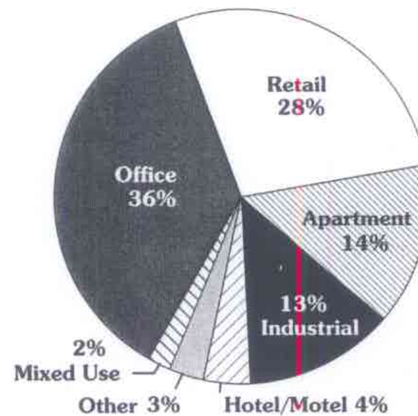
Life Companies' Commercial Mortgage Portfolio Holdings



Principal Outstanding ($000)	
Office	$61,695,397
Retail	$48,265,520
Apartment	$24,093,557
Industrial	$22,845,025
Hotel/Motel	$7,145,606
Mixed Use	$3,554,675
Other	$5,259,907
TOTAL	**$172,859,687**

Source: American Council of Life Insurance

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Barron's/Levy National Mortgage Survey Spreads

September 1984 - September 1994

Source: ©1995 Dow Jones & Co.

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

	Fourth Quarter 1994	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	OCTOBER 3	8.500%	8.500%	8.875%
	NOVEMBER 7	9.000%	9.000%	9.250%
	DECEMBER 5	9.000%	9.000%	9.125%
PRIME MORTGAGE RANGE	OCTOBER 3	8.875-9.000%	8.875-9.000%	9.250-9.375%
	NOVEMBER 7	9.250-9.375%	9.250-9.375%	9.500-9.625%
	DECEMBER 5	9.250-9.375%	9.250-9.375%	9.375-9.500%
PRIME MORTGAGE RATE	OCTOBER 3	9.000%	9.000%	9.250%
	NOVEMBER 7	9.250%	9.250%	9.500%
	DECEMBER 5	9.250%	9.250%	9.375%

Source: ©1994 Dow Jones & Co.

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apartment financing generally is available today for quality properties with 75 percent LTV ratios and minimum 1.2x DSC at 140 to 165 basis points and a maximum of 30-year amortization. Prudently underwritten, these deals can be excellent additions to a portfolio. "B" and "C" quality apartments typically are receiving spreads of at least 210 to 225 basis points from conduits.

In terms of opportunities, hotels offer the greatest potential returns ... achieving spreads of 250 to 400 basis points.

On a selective basis, office properties offer excellent relative value to mortgage lenders. This includes high-quality properties located in the central business districts of major cities as well as key suburban locations. Lenders are still looking very hard at the credit of individual tenants and are requiring escrows for near-term rollovers. Typical terms on most office deals include 10-year maturity, 20- to 30-year amortization, 65 percent to 75 percent LTV ratios and a minimum of 1.20x DSC. Spreads on these deals range from 150 to 200 basis points. For multiple property packages with cross-default and cross-collateralization provisions, spreads can be as low as 130 to 140 basis points.

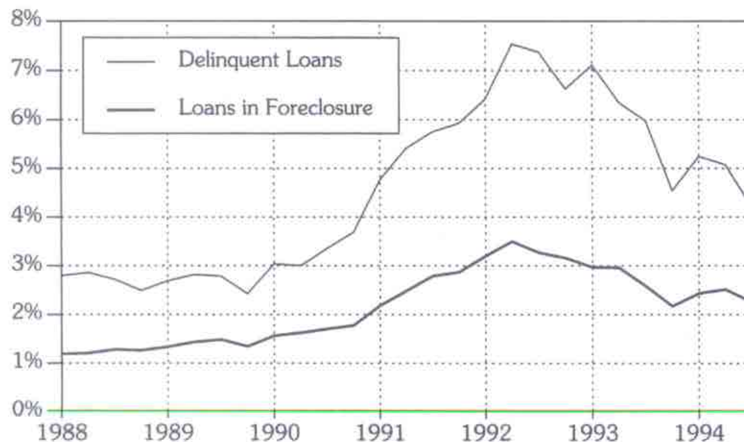
Retail properties are becoming somewhat of a mixed bag. Quality properties, such as anchored neighborhood and community centers located in true in-fill locations and power centers with a high proportion of national credit tenants can make very attractive mortgages. However, lenders need to carefully evaluate the credit prospects of key anchors. For example, certain home electronics retailers such as Best Buy have undergone tremendous expansions and are competing fiercely in most markets. This is a commodity business where price and volume rule; not everyone will survive. K-Mart is another anchor that is becoming difficult to finance. Many lenders are flush with K-Mart credit in their bond and real estate portfolios and are unwilling to take on more at any price. This represents a significant opportunity for lenders who are not over-exposed to K-Mart. Opportunities to lend on regional malls are still very rare as these are often owned by REITs or pension funds.

Industrial properties are as attractive as ever, and as difficult to find. Everybody wants them and yet their small size makes lending on individual properties difficult and not very cost effective. Owners of multiple industrial properties with high-credit tenants are in a position to achieve very favorable financing. Large packages ($20 million and higher), at a maximum of 75 percent LTV can receive spreads of 130 to 150 basis points. Fully cross-defaulted and cross-collateralized packages can reach as low as 125 basis point spreads. Quality individual properties ($5 million to $15 million) typically are quoted at around 150 basis points today.

In terms of opportunities, hotels offer the greatest potential returns if screened properly. Though many lenders are hungrily eyeing hotels today, few have stepped forward. Some conduits, private lenders and one high-profile college endowment are venturing in and achieving spreads of 250 to 400 basis points. Obviously, hotels are a business unto themselves, and therefore lenders should have a thorough understanding of hotel fundamentals.

Another potential area of opportunity is the vast array of borrowers, especially REITs, that borrowed on a floating-rate basis over the past two years when short-term money was very cheap. Currently, the yield curve is flat with three-month Treasury Bills yielding 5.60 percent, nearly double the yield of one year ago. Furthermore, another rise in short-term rates seems possible as the Fed labors to control inflation expectations. Commercial mortgage lenders might receive a modest windfall in 1995 if some of this floating-rate debt converts to fixed. RECMR

Mortgage Loan Delinquencies and Foreclosure Rates (commercial properties, as of September 30, 1994)



Source: American Council of Life Insurance

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