by
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Equitable Real Estate Mortgage Investors

Falling Rates Create a Borrowing Opportunity

Deal Flow Picks Up in Early 1995

Executive Summary

- **Mortgage rates drop about 75 bp in First Quarter**
- **Rates cause some pension funds to move to sidelines**
- **Office properties offer lenders significant upside potential**

Last quarter, we noted that many borrowers missed a tremendous opportunity in the first half of 1994 to refinance commercial properties at nominal mortgage rates that had dropped as low as 7.25 to 8.10 percent. **Today, the combination of fierce lender competition and sagging Treasury rates has created another "borrow opportunity," albeit not quite as attractive as before.** Ten-year mortgages on many A-quality properties are now offered at rates ranging as low as 8.30 percent to 8.80 percent based upon 75 percent loan-to-value ("LTV") and 1.2x minimum debt-service-coverage ("DSC") ratios. These current mortgage rates are, on average, 75 basis points lower than their peak at year-end 1994. This is due largely to the precipitous drop in Treasury rates over the past three months.

Since the middle of 1994, lenders have struggled to capture their fair share of new originations. Early on, lenders competed on spread, and spreads marched steadily downward throughout 1994. By the end of the year, many lenders realized that spreads were approaching bottom. For very attractive deals, a few aggressive lenders began matching the competition on spread and winning deals by sacrificing fees and closing costs. For example, although lenders are accustomed to earning an origination fee from borrowers of 75 to 100 basis points, some lenders were charging only 25 to 50 basis points by year-end. In addition, some lenders were reducing closing costs, particularly where the lender has in-house professional staffs such as legal, appraisal, environmental and engineering.

Today, in addition to capping or paying closing costs, some lenders are waiving tax and insurance escrows. Such escrows were a major underwriting improvement coming out of the recent real estate recession. It is a mistake for lenders to pull-back on underwriting standards at this stage of the market cycle. Others are quoting deals very quickly, often times with a same-day quote.

For investors considering new mortgage programs, the most critical aspect of competition has become discretionary capital. Life insurance companies and conduits typically have discretionary lending programs and can commit to deals quickly. Discretion is very important to sophisticated borrowers who otherwise expect to be compensated for the perceived risks of non-discretionary investment processes.

A BORROWER'S PERSPECTIVE

From a borrower's perspective, market conditions are unlikely to get much better in the foreseeable future. Certainly, there exists a modest potential that spreads will compress further (perhaps 10 to 15 basis points) over the next six months for most quality apartment, industrial, office and retail properties. However, the recent rally in underlying Treasuries (now 6.80 percent to 7.05 percent for five- and 10-year Treasuries, respectively) has probably played out for the near term. Over the next several months, Treasury rates have a higher

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Commercial Mortgage Capital Sources

Lender Requirements*	1Q/94	1Q/95
Insurance Companies/Pension Funds ("A" Quality Real Estate)		
Rates	7.80-8.75%	8.45-8.95%
Spreads (UST)	1.75-2.25 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	6.60-8.65%	8.60-9.20%
Floating	4.50-6.00%	8.25-9.25%
Spreads — Fixed (UST)	2.00-2.75 bp	1.50-2.00 bp
Floating (LIBOR)	1.75-2.50 bp	1.75-2.75 bp
Max. Loan-to-Value	75%	75-80%
Min. Debt Service Coverage	1.15-1.20x	1.15-1.20x
Term	1-5 yrs.	1-10 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	8.50-10.00%	9.30-10.00%
Spreads (UST)	2.50-3.50 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.

probability of rising than falling further. Borrowers facing near-term refinancing needs are urged to take advantage of current conditions and lock in attractive, five- to 10-year fixed-rate mortgages. Of course, spreads have more room to fall for properties that were recently "out-of-the-money" (e.g. certain offices and many hotels). Such borrowers may choose to ride the property cycle a little further before refinancing.

Deal flow has picked up considerably since year-end 1994 when relatively high mortgage interest rates (9.05 percent to 9.55 percent) seemed to scare off many borrowers. Actually, as interest rates reach these levels, borrowing is dampened because it is difficult to generate significant positive leverage unless one "overcollateralizes" his property by borrowing at a low LTV ratio to minimize the interest rate spread. Furthermore, high interest rates act as a natural brake for lenders in that DSC ratios approach minimum levels for fully leveraged properties. On the other hand, at 9.00 percent nominal mortgage rates, lenders are very eager to originate loans when underwriting allows.

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A LENDER'S PERSPECTIVE

While borrowers should be excited about today's low rates, for certain lenders rates have come down too far. **Although life companies can be expected to remain very active, some pension funds have moved to the sidelines or shelved plans for entering the market.** This has slowed considerably the fund-raising efforts of several of the commercial mortgage advisors. However, pension plan sponsors should consider that commercial mortgages still have tremendous relative value as compared to comparable credit corporate bonds, as well as equity real estate capitalization rates. Interestingly, commercial mortgage-backed securities ("CMBS") of all credit qualities are now often viewed as having greater relative value than whole loan investments. This has diverted some sizable fixed-income allocations to CMBS that otherwise might have flowed to corporate bonds, government bonds and even whole loan investment programs. This is one of the strongest fundamental factors that will cause whole loan spreads to level off, or at most to drop only modestly.

In terms of specific investor appetites, office properties are now generating considerably more interest than just a short time ago. Over the past year they have moved from second-to-last (hotels being last) to first on many shopping lists. Generally, lenders do not seem to discriminate between central business district and suburban locations, although the "24-hour city" concept still has considerable pizzazz. (Twenty-four-hour cities have vibrant residential and cultural components to complement their business district cores.) The interest in 24-hour cities is not merely a fad of institutional investors, but instead a return to common sense real estate fundamentals that are reflected in most mortgage lending today. Spreads on quality offices remain relatively high at 140 to 165 basis points. Lenders remain very concerned with 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 25-year amortization, 65 percent to 75 percent LTV ratios and a minimum of 1.25x DSC. Valuations of offices are still conservative as compared to all other major property types other than hotels. As a result, loans on office properties offer excellent opportunities today.

Hotels finally have moved onto the radar screens of certain lenders who correctly perceive that the market continues to misprice some hotel properties; this can translate into significant excess returns. While there is considerable discussion of hotels today among traditional whole loan lenders, few have stepped forward. To date, some conduits and private lenders have been active, achieving spreads of 250 to 400 basis points. The general perception is that hotel fundamentals are improving, and certain properties are improving much more quickly than others. This, coupled with the need to put money to work at higher rates, will draw more traditional lenders into the market over the next six months. As long as due diligence is performed carefully, this should be a very profitable sector. (Lenders probably will have to be willing to accept narrower spreads in order to win the most fundamentally sound hotel deals on the best possible terms, however. Spread can never compensate for a poor deal.)

Retail properties require careful scrutiny today. 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, nearly every major market recently has witnessed an increase in the supply of power center product. In addition, tenant credit and store

formats, particularly for "big box" retailers, must be studied very carefully. Also, co-tenancy clauses should be viewed with caution. The watch words today for retail real estate are "Location, Location and Cost-Effective Product Delivery Systems." Store formats are not fungible from one large user to the next, and configurations seem to become obsolete very quickly. Having said that, quality retail properties are achieving spreads of 130 to 150 basis points for loans with 75 percent LTV and 1.2x DSC ratios.

Apartment and industrial projects are still attracting tremendous competition. This is due, in part, to a perception of strong fundamentals in many markets, the inflation-sensitive nature of 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. Overall, the apartment market offers many solid opportunities, but we remain concerned about fundamentals in several hot markets such as Atlanta, where single-family developments and apartment projects are booming. Apartment financing is widely available today for quality properties with 75 percent LTV ratios and minimum 1.2x DSC at 130 to 150 basis points and a maximum of 30-year amortization. Spreads on certain individual industrial properties have fallen as low as 120 basis points. Lenders have a difficult time reaching their industrial allocation targets due to the small size of most deals.

Perhaps the best opportunities today, given where we are in the real estate cycle, are to be found in tactical bets on quality properties at above normal LTV ratios. For example, many office owners currently are having a difficult time fully refinancing their properties on a traditional whole loan basis. Lenders willing to advance 80 percent to 85 percent LTV (based upon very conservative underwriting) are achieving spreads as high as 400 basis points over Treasuries. From the lender's perspective, this is a better strategy in some cases as compared to "soft second" or "mezzanine" investments, which have many of the same risks as high-LTV first-mortgage positions, but fewer controls. Of course, these opportunities require very careful analysis and should only be taken on a highly selective basis. RECMR

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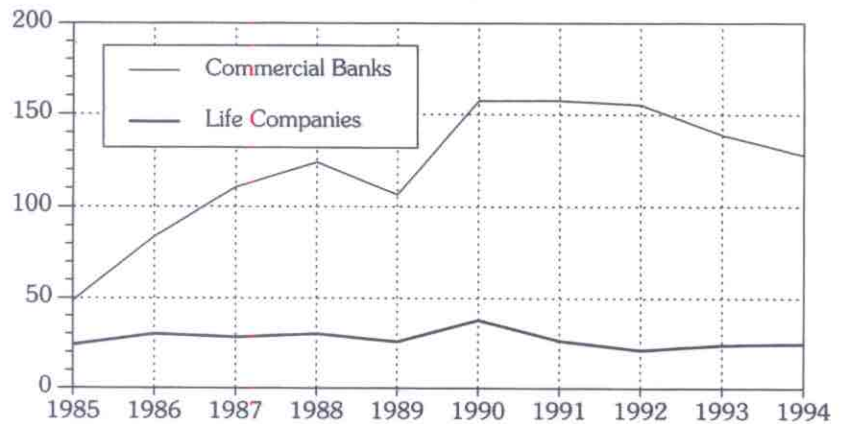
Commercial Real Estate Loan Volume (\$ billions)



Source: Department of Housing and Urban Development

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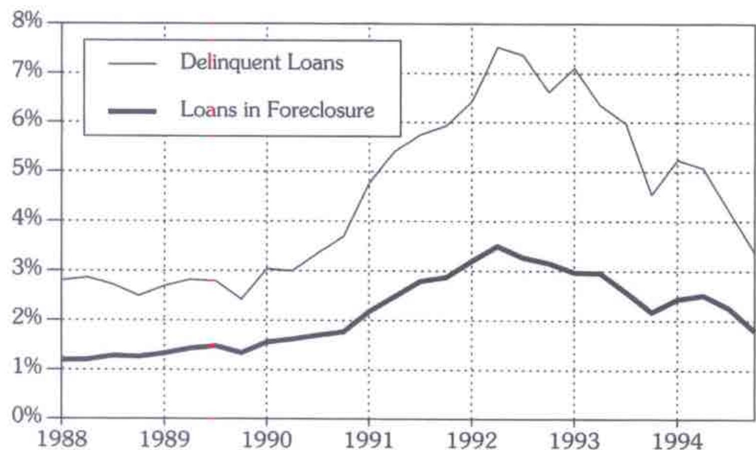
Mortgage Loan Delinquencies and Foreclosure Rates (commercial properties as of December 31, 1994)



Source: American Council of Life Insurance

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

	First Quarter 1995	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	JANUARY 9	9.000%	9.125%	9.125%
	FEBRUARY 6	8.875%	8.875%	9.000%
	MARCH 6	8.125%	8.125%	8.250%
PRIME MORTGAGE RANGE	JANUARY 9	9.000-9.250%	9.125-9.250%	9.250-9.375%
	FEBRUARY 6	9.000-9.125%	9.000-9.125%	9.125-9.250%
	MARCH 6	8.500-8.625%	8.500-8.625	8.625-8.750%
PRIME MORTGAGE RATE	JANUARY 9	9.125%	9.250%	9.250%
	FEBRUARY 6	9.000%	9.000%	9.125%
	MARCH 6	8.625%	8.625%	8.750%

Source: ©1995 Dow Jones & Co.

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