PRIVATE DEBT MARKETS

Debt Market Feels Pressure of Rising Interest Rates

Increased Competition Leading to Aggressive Bidding

by
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The recent increase in U.S. Treasury yields has significantly altered conditions in the commercial mortgage market. This is the time of year when many lenders traditionally step-up loan commitment activity to ensure that deals close by year-end. However, the rate increase has caused some prospective borrowers to wait, unless faced with an immediate loan maturity. This, coupled with a heightened lender demand for mortgages, may result in many lenders missing their allocation targets for the year.

Ten-year Treasuries were yielding 5.75 percent at the beginning of 1994, as compared to 7.65 percent in early October. At the same time, spreads on quality commercial mortgages have narrowed sharply from 225+ basis points in January to 150 basis points (ranging from 125 to 175 basis points) today. On a nominal basis, commercial mortgage interest rates were approximately 8.0 percent in January versus 9.0 percent to 9.25 percent on most deals today. From the borrowers' perspective, the opportunity to lock-in long-term financing at historically low rates is past. Today's market offers the ability to borrow reasonable sums at reasonable rates.

From the lenders' point of view, it is a bit of a mixed bag. On one hand, spreads are down and while mortgages still offer excellent relative value, it is less than before. On the other hand, many lenders find 9.0 percent nominal mortgage rates to be very compelling and are unconcerned with the spread issue. In a historical context, for many years, life insurance companies routinely originated quality commercial mortgages at spreads averaging 125 basis points and justifiably felt well compensated. Today, there is more liquidity in the mortgage market than ever before and liquidity continues to increase. Today's spreads of 150 basis points still contain a good deal of excess compensation. Recently, there have been several deals done as low as 125 basis points, however, these are low loan-to-value (LTV) transactions or deals with high-credit tenants and heavy amortization. Such deals would normally merit a credit quality rating of "A" or better.

Optimism about the economy, a general comfort that commercial real estate markets have stabilized and the growing securitization wave are all contributing to a heightened level of competition for commercial mortgage loans. Life insurance companies, pension funds, banks and conduit programs are bidding very aggressively for loans of all sizes and quality. As noted, this has driven spreads down. In addition, a troubling relaxation of underwriting standards is evident. Talk of Wall Street conduits offering apartment loans at 80 percent LTV, and life insurance companies offering 32-year amortization schedules on retail loans is indicative of some overheating.

Equally distressing is the ballooning number of conduit wannabes. Commercial mortgage securitization is a classic economy of scale business. It is volume and margin driven, and over time the lowest cost providers will dominate the market. Lenders assembling $50 million pools of B- and C-quality loans had better

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Commercial Mortgage Capital Sources

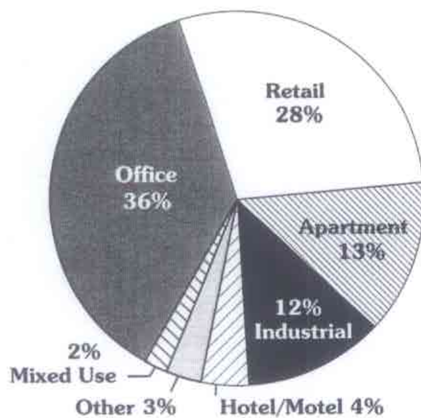
Lender Requirements*	3Q/93	3Q/94
Insurance Companies ("A" Quality Real Estate)		
Rates	7.25-8.00%	8.75-9.45%
Spreads (UST)	2.00-2.50 bp	1.25-1.75 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.20x	1.20x
Term	7-10 yrs.	7-10 yrs.
Commercial Banks ("A" Quality Real Estate)		
Rates — Fixed	5.65-7.70%	9.50-10.00%
Floating	4.50-6.00%	7.25-7.50%
Spreads — Fixed (UST)	2.25-2.75 bp	2.00-2.25 bp
Floating (LIBOR)	1.50-2.00 bp	1.75-1.90 bp
Max. Loan-to-Value	75%	75%
Min. Debt Service Coverage	1.25x	1.15-1.20x
Term	1-5 yrs.	1-10 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	8.25-9.00%	9.75-10.75%
Spreads (UST)	3.25-3.50 bp	2.25-3.00 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.

Life Companies Commercial Mortgage Portfolio Holdings

(as of June 30, 1994)



	Principal Outstanding ($000)
Office	$63,439,214
Retail	$48,603,249
Apartment	$24,761,451
Industrial	$23,222,325
Hotel/Motel	$7,440,161
Mixed Use	$3,573,161
Other	$5,480,422
TOTAL	**$176,519,950**

Source: American Council of Life Insurance

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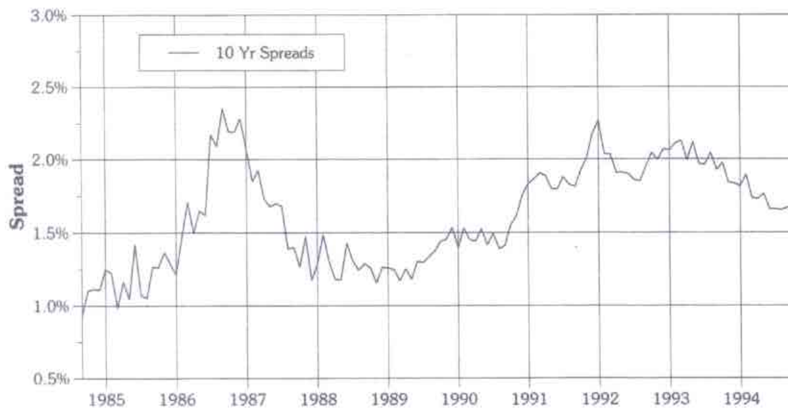
Barron's/Levy National Mortgage Survey Spreads



September 1984 - September 1994

Source: ©1994 Dow Jones & Co.

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

	Third Quarter 1994	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	JULY 4	8.375%	8.375%	8.625%
	AUGUST 8	8.000%	8.000%	8.375%
	SEPTEMBER 6	8.250%	8.250%	8.375%
PRIME MORTGAGE RANGE	JULY 4	8.500-8.625%	8.500-8.625%	8.875-9.000%
	AUGUST 8	8.375-8.500%	8.500-8.625%	8.750-8.875%
	SEPTEMBER 6	8.375-8.500%	8.500-8.625%	8.750-8.875%
PRIME MORTGAGE RATE	JULY 4	8.500%	8.625%	8.875%
	AUGUST 8	8.375%	8.500%	8.750%
	SEPTEMBER 6	8.500%	8.625%	8.875%

Source: ©1994 Dow Jones & Co.

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be comfortable holding these loans over the long term, because they may have no choice if securitization market conditions sour. Most lenders are advised to originate loans that they are comfortable with on a "buy and hold" basis, and take advantage of securitization if it is available, but do not count on it.

Potential borrowers are finding abundant capital for most property types and locations. While borrowers may not like the cost of funds for certain contrarian investments, such as hotels, nonetheless money is widely available today. Office properties, in particular, have rebounded smartly in the eyes of many lenders. While office fundamentals are still somewhat suspect (witness the never-ending stream of corporate "right-sizings"), on a selective basis they can be the best values today for mortgage lenders. Lenders should not discriminate between CBD and suburban office locations, but should consider each deal on its individual merits. Especially desirable locations today for office investments are the "edge-city" locations, such as the Buckhead area of Atlanta. Class-A office buildings with credit tenants on leases that extend past the term of the mortgage are especially desirable. 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 debt service coverage (DSC). Escrows for near-term tenant improvement capital will often be required. 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 130-140 basis points.

In the apartment market, Wall Street's habit of slaying the golden goose may result in some casualties (directly or indirectly). Today, many REITs are flush with cash and bank lines of credit for new apartment construction. In addition, apartments seem to be on the shopping lists of most institutional equity investors. Thus, apartment valuations are typically "full," at a time when some lenders are increasing LTV ratios to 80 percent. At this point in the property cycle, we believe that more scrutiny and more thorough underwriting of apartment mortgage opportunities are required. We encourage lenders to be very selective and cautious. Having said that, apartment financing is generally available today for quality properties with 75 percent LTV ratios and minimum 1.2x DSC

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at 150 to 175 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 are typically receiving spreads of at least 225 basis points from conduits.

Owners of multiple industrial properties with high-credit tenants are in a position to achieve very favorable financing.

Retail properties lie somewhere between offices and apartments in terms of relative value. 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 (as opposed to "mom and pop" stores), are highly sought after. Deals of $5 million to $35 million regularly come to market and appeal to a very broad range of lenders from small life companies to large state pension funds. Especially appealing are centers close to major regional malls. An eye-opening recent transaction in an Atlanta suburb is indicative of current conditions. A major life insurance company reportedly loaned $35 million at a spread of 125 basis points and a 32-year amortization schedule on a new 440,000-square-foot power center across the street from a regional mall. Given a 62 percent LTV ratio and 1.5x DSC ratio, this spread is acceptable, though barely. Opportunities to lend on regional malls are still very rare as these are often owned by REITs or suitable for securitization on a low-cost floating-rate basis.

Industrial properties are highly sought after, but given their small size, they are difficult to assemble into significant portfolios. 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 135 to 150 basis points. Fully cross-defaulted and cross-collateralized packages can reach as low as 125-basis-point spreads. Individual properties ($5 million to $15 million) are typically quoted at 150 basis points today.

Lenders seeking yield and willing to take some risk might consider hotel loans. Hotels are now where office properties were about two years ago. Red-lined by most lenders, both good and bad deals have been lumped together as too risky. Some conduits and private lenders are venturing in and achieving spreads of 300 to 400 basis points. Carefully screened and with significant reserves in place for capital improvements and operating shortfalls, some excellent opportunities can be found. Obviously, hotels are a business unto themselves, and therefore lenders should have a thorough understanding of hotel fundamentals. RECMR

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ECONOMIC OUTLOOK

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significant pressure. As the graph Economic Outlook 5 shows, the ratio between the Federal Funds rate and the 90-day T-bill rate is typically positive, and becomes more positive during periods of economic expansion. Assuming the average spread of 85 basis points, Fed Funds are under considerable pressure to move into the 5 percent to 5.5 percent range. This is likely to happen after the November elections and into the new year.

Inflation pressures remain high. The Leading Index of Inflation, developed and maintained by the Center for International Business Cycle Research at Columbia Business School, is still giving its highest readings since 1982, and is posting new highs on a monthly basis. Ned Davis Research's inflation forecasting model is generating similar readings, while the Bank Credit Analyst also finds evidence that inflation pressures are growing. The widely watched Total Capacity Utilization figure is flirting with the 85 percent threshold, regarded as an important inflation trigger because it reflects the capacity of U.S. production facilities to meet rising demand (see Economic Outlook 6).

The Consumer and Producer Price Indices, lagging indicators of inflation, also appear to reflect growing inflation pressures. The current action of these indicators is similar to the spring of 1993, which spooked the markets and economists alike with the fear of imminent price hikes (see Economic Outlook 7). Higher prices did not materialize at that time, but probably will today. Critical thresholds to watch for the PPI and CPI numbers to confirm an environment change are 3 percent and 3.5 percent, respectively. RECMR

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