by
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Equitable Real Estate

Borrowers Enjoy Smorgasbord of Financing Options

Lenders Scramble to Meet 1994 Allocation Targets

Pension funds, conduits, mutual funds and bond managers now represent formidable competition for the old guard.

The commercial mortgage market is back in full-swing with many lenders willing to consider all offerings on their individual merits, regardless of property type. As well, borrowers often are faced with the enviable problem of having to choose between several attractive financing alternatives.

Typical institutional-grade properties can be financed on traditional terms at as much as 65 percent to 75 percent loan-to-value (LTV) at interest rates of 150 to 200 basis points over Treasuries. For a 10-year term, this translates into an 8.50 percent to 9.00 percent coupon. At these nominal levels, life insurance companies and pension funds justifiably begin to get fairly excited. On the flip side, these rates are low enough to generate attractive loan proceeds for borrowers while remaining well within prudent debt service coverage (DSC) ratios.

Players re-entering the market after a long hiatus will be surprised at how much it has changed, or better, how much it has evolved. Would-be borrowers find themselves at the intersection of Wall Street and Main Street, where they are confronted with a dizzying smorgasbord of public and private financing options. All too often, borrowers have been bogged-down analyzing every alternative while rates have moved against them. Some would have been better off had they flipped a coin six months ago and locked in historically low rates.

Fortunately, as of late, a natural order seems to be taking shape in the market as borrowers and lenders gravitate toward their appropriate niches. Conduits are all the more focused on higher-yielding and lower-quality properties, having recognized that they cannot compete on rate with life insurance companies and other "portfolio" lenders for most high-quality properties.

From the lenders' perspective, there is a great deal of relative value in commercial mortgage whole loans as compared to alternative fixed-income products. Lenders recognize the good sense in writing loans at high spreads on properties at the bottom of the value cycle. From a credit standpoint, a typical institutional-grade mortgage today would be of "A" to "BBB" quality. For a 10-year mortgage at 9.00 percent, this represents approximately a 60 to 90 basis point premium over a similar credit corporate bond, which more than compensates the lender for the low liquidity of the mortgage. As a result, over the past six to nine months, experienced lenders have steadily returned to the market. Many insurance companies, banks and foreign lenders are back in the game. Commercial banks, in particular, are actively competing for seven- to 10-year loans on both fixed- and floating- (over LIBOR) rate bases.

In addition, the ground swell of interest in mortgages by new institutional players continues to grow. Pension funds, conduits, mutual funds and bond managers now represent formidable competition for the old guard, and this will only increase.

The new players are having an additional impact in that they are rewriting some of the rules by which the game is played. For example, pension funds need

Commercial Mortgage Capital Sources

Lender Requirements*	2Q/93	2Q/94
Insurance Companies ("A" Quality Real Estate)		
Rates	7.60-8.75%	8.50-9.10%
Spreads (UST)	2.00-2.75 bp	1.50-2.00 bp
Max. Loan-to-Value	65-75%	75%
Min. Debt Service Coverage	1.20x-1.25x	1.20x
Term	7-10 yrs.	7-10 yrs.
Commercial Banks ("A" Quality Real Estate)		
Rates — Fixed	5.75-8.00%	7.25-9.50%
Floating	5.20-5.75%	6.50-7.25%
Spreads — Fixed (UST)	2.25-2.75 bp	2.00-2.50 bp
Floating (LIBOR)	1.75-2.25 bp	1.50-2.25 bp
Max. Loan-to-Value	70%	75%
Min. Debt Service Coverage	1.25x	1.15x-1.20x
Term	1-5 yrs.	1-10 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	8.50-9.50%	9.00-10.00%
Spreads (UST)	3.25-3.50 bp	2.25-3.00 bp
Max. Loan-to-Value	70%-75%	75%
Min. Debt Service Coverage	1.30x+	1.20x
Term	5-10 yrs.	5-10 yrs.

* Represents typical transactions, not full range.

Source: Equitable Real Estate Investment Management, Inc.

to recognize periodically the market value of their assets (including mortgage loans), at least quarterly. This requires that borrowers provide them information in the form of rent rolls and audited financial statements on a regular basis. In addition, pension fund managers often have significant experience with bond investing and therefore are keenly focused on the credit quality of both tenants and borrowers. Borrowers need to understand that these trends are not a threat; in fact, they will lead to lower borrowing rates over time. As a final example, more information about individual properties eases the rating agency analysis of securitized offerings. This can translate into a better credit rating for the offering and therefore tighter pricing. Ultimately, this too results in lower interest rates for borrowers.

COMPETITION INCREASES, SPREADS NARROW

In terms of investor preferences, office properties have gained considerable ground during 1994, and are now competitive with other property types. Especially appealing are Class A office buildings with credit tenants on leases that extend past the term of the mortgage. Typical terms include 10-year maturity, 20-year amortization, 65 percent to 70 percent LTV ratios and a minimum of 1.20x DSC. Underwriting will typically include escrows for near-term tenant improvement capital. Spreads on these deals range from 165 to 200 basis points with most deals being done at the higher end of the range (and some notable exceptions in the 140s). Multi-tenant offices typically achieve LTVs of 65 percent maximum and require greater amortization. There does not seem to be a clear distinction in the market between CBD and suburban; it's really a function of the individual lender and the property's "story."

The picture for apartments, industrials and smaller retail and hotels continues to be complicated by the competition from conduits. Properties of $15 million and less are readily securitized because it is easy to assemble highly diversified pools, a key factor for rating agencies. However, the conduits require relatively high spreads to make the expensive securitization process profitable. Therefore, they are focused on higher-yielding assets ("B" and "C" quality) within each property type. Conduit rates have marched steadily downward over the last year with spreads for apartments now ranging from 225 to 275 basis points. Anchored retail centers with several years of operating history can be financed for 285 basis points, while unanchored centers and new centers can range as high as 350 basis points. Industrial spreads range from 300 to 400 basis points, and hotels, the latest entrants to the field, require 325 to 450 basis point spreads. Borrowers from conduits must be willing to accept standardized loan documents and lock boxes. Further, many conduits do not lock-in interest rates until shortly before closing.

Traditional lenders have an insatiable appetite for high-quality apartments and several life insurance companies are now offering floating-rate financing as well as fixed. Lenders will generally offer 75 percent financing based upon 8.00 percent to 9.00 percent capitalization rates. At spreads of 150 to 200 basis points, excellent opportunities are still available, but lenders are cautioned to be on the lookout for new construction in certain markets, such as Atlanta. In particular, some real estate investment trusts (REITs) have essentially unconstrained lines of credit for apartment construction.

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A number of attractive retail opportunities in the $15-35 million range have come to the market in the last several months. These are power centers or large community centers with superb locations. Such deals are typically getting spreads of 175 to 200 basis points with some as high as 225. Larger retail offerings are still very scarce because many malls are owned by REITs, which often use bank lines of credit as opposed to traditional mortgage financing. In addition, many malls are suitable for single-asset securitization and several

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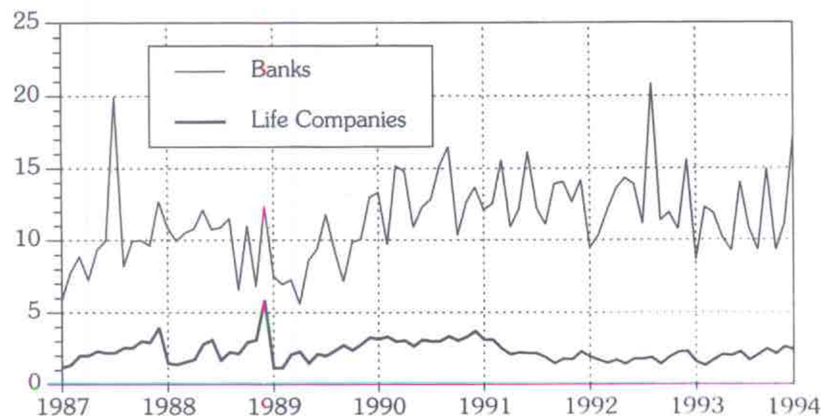
Commercial Real Estate Loan Volume ($ billions)



Source: U.S. Department of Housing and Urban Development

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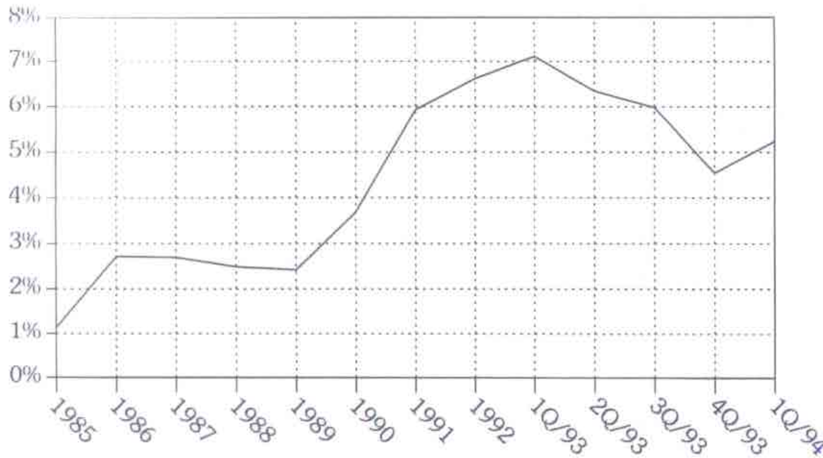
Commercial Mortgage Loan Delinquency Rates



Note: Delinquencies include loans in the process of foreclosure.
Source: American Council of Life Insurance

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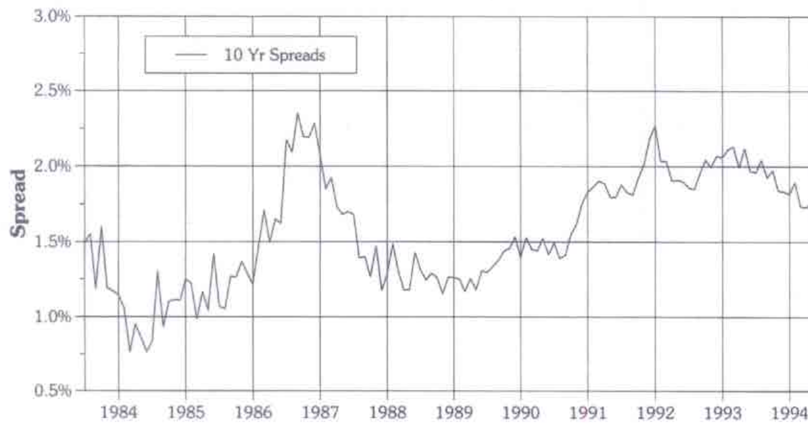
Barron's/Levy National Mortgage Survey Spreads



June 1983 - June 1994

Source: ©1994 Dow Jones & Co.

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

	Second Quarter 1994	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	APRIL 4	7.500%	7.875%	8.125%
	MAY 9	8.250%	8.250%	8.625%
	JUNE 6	8.000%	8.125%	8.375%
PRIME MORTGAGE RANGE	APRIL 4	8.000-8.250%	8.125-8.375%	8.500-8.625%
	MAY 9	8.250-8.500%	8.500-8.625%	8.750-8.875%
	JUNE 6	8.375-8.500%	8.500-8.625%	8.750-8.875%
PRIME MORTGAGE RATE	APRIL 4	8.125%	8.250%	8.500%
	MAY 9	8.500%	8.625%	8.875%
	JUNE 6	8.500%	8.625%	8.750%

Source: ©1994 Dow Jones & Co.

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went this route in 1993. Nonetheless, spreads for quality malls on a traditional basis have dropped as low as 130 to 140 basis points.

Larger institutional players have not been competitive on individual industrial properties, which are the domain of the small-to-mid-sized life insurance companies. In order to put money to work efficiently, larger lenders prefer deals of $15-50 million, and more. This desire for larger deals, coupled with a growing comfort with market fundamentals, has caused some lenders to seriously consider select mixed-use facilities.

In terms of market niches, typical deals completed recently are seven- to 10-year terms with a 25-year amortization schedule. However, there are several borrowers in the market who are seeking longer financing (i.e., 15- to 20-year terms), hoping to capitalize on today's low rates. Lenders who are able to offer longer-term deals (e.g. 20-year term, fully amortizing) can capture some very attractive product.

There is another area of opportunity for lenders willing to offer long-term debt with step-up interest rate schedules in order to get borrowers over near-term debt service coverage problems. Borrowers seeking value should consider packaging properties of the same type on a cross-default and cross-collateralized basis. This approach can reduce the cost of funds to below 150 basis points, which is highly competitive with the securitization alternative.

Over the next several months one can expect spreads to fall somewhat further as more lenders enter the market and other lenders attempt to satisfy their 1994 allocation targets (to ensure closing by year-end, deals need to be signed-up by October). In addition, this summer, several conduits are expected to bring their first securitizations to market. In the short run, this will funnel off some demand for whole loans. But the longer-term impact will be a fresh supply of capital to start the conduit cycle over. There is, of course, a natural floor to mortgage spreads (public and private), which is based upon a liquidity premium over comparable credit corporate bonds. Fortunately, we are not there yet.

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