Frenetic Loan Pace Slows in Fourth Quarter

Low Rates Should Fuel Strong Loan Demand in 1996

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In many respects, 1995 was a very good year for the commercial mortgage markets. Many lenders jumped on strong market fundamentals and originated loans at near-record volumes. Borrowers also enjoyed extremely low five- to 10-year Treasury rates (5.4 to 5.8 percent by year-end) and benefited from increased lender competition. Delinquencies are down to their lowest level in over five years, reflecting the cautious underwriting standards that lenders have demanded of borrowers.

By the Fourth Quarter, however, new loan commitments had slowed noticeably as compared to the first two quarters of the year. This year-end fall-off was due to a variety of reasons. Several large lenders who had already reached their allocation targets were content to focus on closing commitments made earlier in the year. Several other lenders appeared to move to the sidelines in the face of continually falling Treasury rates, which drove mortgage rates as low as 7.00 percent by year-end. Some lenders set mortgage rate "floors" of 7.50 percent and as a result were priced out of the market during the Fourth Quarter. Finally, and perhaps most notably, some key lenders have exited the market as a result of mergers or strategic moves out of the asset class. For example, the acquisition of Connecticut Mutual by Massachusetts Mutual and New England Life by Metropolitan Life will stifle some demand going forward. Further, the outright withdrawal from the market by Aetna and Prudential will have a significant impact, particularly in the market for larger loans.

Likely, 1995 will be looked back upon as a key transitional year in the current real estate and mortgage lending cycles. The fundamental factors noted above, coupled with some emerging trends, will make 1996 the year that separates the pros from the amateurs with respect to the quality and performance of new loan originations. **Unlike the past four years, lenders will not be able to simply rely on extraordinarily strong market fundamentals and over-collateralized loans to buoy otherwise mediocre properties.** In several markets and certain property types, especially retail, overbuilding and tenant credit issues have become real problems. Considerable caution is warranted. Nonetheless, lenders with large allocations will be under pressure to invest in marginal deals.

We have detected some clear slippage in underwriting standards recently. For example, in cash-flow projections, steady 4 percent per year rent growth assumptions over 10-year periods are common. In addition, modest allowances for tenant concessions on offices and insufficient reserves on older apartment projects are problems waiting to happen. Prudent underwriting and selectivity will be the hallmark of successful lenders during 1996.

Demand for loans will be very strong this year, particularly in the $1 million to $20 million size range. Mid- to small-sized life insurance companies report increased

— Continued on next page

Executive Summary

- **Despite a year-end slowdown, lenders originated loans at a near-record clip in 1995**
- **Office properties are "hot" as they have a long way to go before reaching the top of their cycle**

Commercial Mortgage Capital Sources

Lender Requirements*	4Q/94	4Q/95
Insurance Companies/Pension Funds ("A" Quality Real Estate)		
Rates	9.10-9.75%	6.75-7.50%
Spreads (UST)	1.25-1.75 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	8.75-9.80%	6.65-7.50%
Rates — Floating	8.75-9.50%	6.75-8.00%
Spreads — Fixed (UST)	1.50-2.00 bp	1.35-2.00 bp
Spreads — Floating (LIBOR)	1.75-2.50 bp	1.25-2.50 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	9.85-10.50%	7.50-8.25%
Spreads (UST)	2.10-2.75bp	2.00-2.75 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.

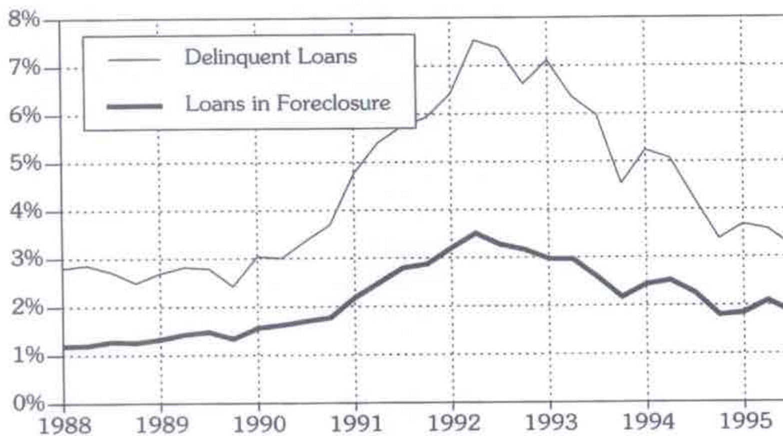
Barron's/Levy National Mortgage Survey Spreads

January 1986 - December 1995

Source: John B. Levy & Company © 1995

Private Debt 2

Mortgage Loan Delinquencies and Foreclosure Rates



Source: American Council of Life Insurance

Private Debt 3

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

	Fourth Quarter 1995	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	OCTOBER 2	7.375%	7.500%	7.500%
	NOVEMBER 6	6.875%	7.000%	7.250%
	DECEMBER 4	6.875%	7.000%	7.125%
PRIME MORTGAGE RANGE	OCTOBER 2	7.500-7.625%	7.625-7.750%	7.750-7.875%
	NOVEMBER 6	7.000-7.250%	7.125-7.375%	7.250-7.500%
	DECEMBER 4	7.000-7.125%	7.125-7.250%	7.250-7.375%
PRIME MORTGAGE RATE	OCTOBER 2	7.500%	7.625%	7.750%
	NOVEMBER 6	7.125%	7.250%	7.375%
	DECEMBER 4	7.000%	7.125%	7.250%

(For loans $5 million and up)
Source: John B. Levy & Company © 1995

Private Debt 4

allocations to commercial mortgages and are expected to hotly compete for deals of this size. Furthermore, the surviving Wall Street conduits are well-capitalized and have developed highly efficient loan origination machines. They will continue to be a key factor on "B" and lower-quality properties and will begin to move into higher-quality properties. **This may also be the year we finally see Wall Street making a significant move into $10 to $30 million sized loans.** This will not be easy, as several large traditional life insurance company lenders, such as Principal and Northwestern, will have a lot of money to invest in 1996 and will aggressively defend their traditional turf.

With spreads on quality properties stabilized in the 125 to 175 basis points range for fixed-rate loans, coupled with the projected low interest rate environment during the 1996 election year, borrowers should be very well-positioned for some time to come. **Ten-year mortgages on many "A" quality properties are now offered at rates ranging as low as 6.75 percent to 7.50 percent based upon 75 percent loan-to-value ("LTV") and 1.2x minimum debt-service coverage ("DSC") ratios.** These current mortgage rates are 200 basis points lower than their peak at year-end 1994. This is due largely to the precipitous drop in Treasury rates over the past year.

In terms of specific investor appetites, office properties are now generating a broad level of interest and seem to be on most lenders' shopping lists. Both CBD and suburban office projects are fair game, although lenders still seem to lean toward suburban. Spreads on quality offices remain relatively high at 140 to 165 basis points. Lenders are still very concerned with the credit of individual tenants and are requiring escrows for near-term rollovers. However, as compared to a year ago, lenders are less cautious in their cash flow models with regard to assumptions on tenant renewal probabilities. 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. **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.** For 1996, the big question on offices is who will be willing to lend on large properties of $50 million or more. Several loans on signature CBD properties are rolling, such as the AT&T

building in Chicago. At this point, the best bet for large office loans is securitization.

Hotels are getting much more attention today than they have in years, and rightfully so. The market continues to misprice some hotel properties; this can translate into significant excess returns. Though there is considerable discussion of hotels today amongst traditional whole loan lenders, few have stepped forward. To date, some conduits and private lenders have been active, achieving spreads of 225 to 400 basis points. Nomura has been a major lender to the hotel sector, which accounted for a sizable percentage of its recent MegaDeal IV securitization. The general perception is that hotel fundamentals are improving — and certain properties 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 carefully performed, this should be a very profitable sector. However, lenders should be willing to accept narrower spreads in order to win the most fundamentally sound hotel deals on the best possible terms.

Retail properties require tremendous scrutiny today. The recent bankruptcy filings by Edison Brothers, Bradlees, Jamesway and Caldor have left shopping center owners reeling. Other household names that are very questionable credits include Kmart, Service Merchandise and Best Buys. In addition, during 1995 retail construction set a torrid pace in several markets across the country. Having said that, quality retail properties are achieving spreads of 130 to 175 basis points for loans with 75 percent LTV and 1.2x DSC ratios. Quality properties, such as anchored neighborhood and community centers located in true in-fill locations, power centers located adjacent to major regional malls with a high proportion of national credit tenants and truly dominant regional malls can make very attractive mortgages.

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 make these deals 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 residential development 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 very difficult time reaching their industrial allocation targets due to the small size of most deals. Certain markets are especially appealing, such as the Silicon Valley in Northern California and markets throughout the Midwest. RECMR

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Mortgage Portfolios Post Improving Delinquency Rates

Mortgage portfolios continued to shape up, according to the most recent data released by the American Council of Life Insurance (ACLI). Since peaking at 7.53 percent in the Second Quarter of 1992, commercial mortgage delinquency rates have steadily fallen. As of Sept. 30, 1995, rates stood at 3.22 percent, a 36 basis point drop from the previous quarter. Loans in process of foreclosure also moved lower, falling to 1.84 percent from 2.09 percent.

Commercial foreclosures were off by one third, totaling $2.4 billion in the first three quarters of 1995, compared to $3.6 billion in the comparable period in 1994. The foreclosures were dominated by the office sector, which accounted for a 61 percent share. Office buildings account for 35 percent of insurance companies commercial mortgage holdings. In contrast, apartments, which represent 14 percent of portfolio holdings, only accounted for 5 percent of foreclosures.

Six of nine geographic areas in the U.S. reported lower delinquencies and one was unchanged. The South Atlantic improved 79 basis points to 2.12 percent, the Middle Atlantic (4.52 percent) and Pacific (3.64 percent) regions showed improvements of 116 and 25 basis points, respectively.

Office, retail and industrial properties all recorded better results in the latest period, with office and retail reaching their lowest levels in five years. RECMR