Lenders Unable to Satisfy Appetites for Mortgages

Borrowers Head to the Sidelines to Await Drop in Rates

by
Walter R. Huggins
Equitable Real Estate Investment Mgmt., Inc.

Executive Summary

- **Rates have climbed 50–75 basis points in the past year**
- **Office and hotel spreads shrink, while spreads on power centers have increased**
- **Wall Street eyeing mega-loans for securitization**

During the Second Quarter, borrowers took to the sidelines awaiting a reduction in interest rates that many economists predicted would occur. Both borrowers and economists have been proven wrong, leaving many economists embarrassed and many borrowers poorer for the delay.

Ten-year Treasury rates were at 7.19 percent at the end of March 1995 and 6.2 percent by the end of June that year; coupon rates ranged from 7.25 percent to 7.75 percent. At the end of March 1996 the 10-year Treasury rate was 6.32 percent and increased to 6.7 percent at the end of June, pushing coupon rates to the 8.0 percent to 8.5 percent range. These rates are high by recent standards, but not historically. For those borrowers who have waited several months for rates to drop, it has cost them 50 basis points in rate, which amounts to around $40,000 per year, or 4 percent over 10-years, for a 10-year term, $10 million loan at 8.0 percent with a 25-year amortization schedule.

Perhaps today's borrowers are faced with too many options. Some borrowers appear to be looking for the ultimate deal while they ponder which direction Treasury rates might be going. To make up for lost time, some borrowers expect lenders to approve and close loans more quickly than possible, or give up on key loan provisions that have brought so many lenders back to the market. Lenders want good loans with good borrowers who focus on the major points, rather than fighting over every issue.

In today's market, many lenders have been unable to satisfy their appetites for commercial mortgages. Life insurance companies alone, for example, invested more than $20 billion in new whole loan commitments during 1995. In addition, they were a major reason the commercial mortgage-backed securities (CMBS) market was able to do in excess of $20 billion last year, and currently is on record pace after the first six months of 1996. The demand for CMBS will continue to fuel the conduit market and bring more Wall Street capital to this market for larger loans that are ideal for single-asset securitizations.

Real estate values for most property types are increasing, as cap rates decrease in the face of increased competition for quality assets (with the possible exception of retail); as market fundamentals continue to improve (lower vacancy rates); and as effective rental rates increase producing higher values. This trend should continue to make lenders comfortable with commercial mortgages, and continue to improve liquidity. **Now is the time to really focus on values and future income projections, as purchase prices are exceeding reproduction costs for many property types, with the exception of perhaps hotels and some CBD office projects.** Excess profits often breed ruinous competition, so expect to see more speculative construction and build-to-suit activity over the next 24 months; only a recession, also predicted by some economists, could delay this trend.

What does this mean for lenders? For banks, it translates into new construction loans and/or mini-perms. This may divert

Commercial Mortgage Capital Sources

Lender Requirements*	2Q/95	2Q/96
Insurance Companies/Pension Funds ("A" Quality Real Estate)		
Rates	7.25–7.75%	7.80–8.45%
Spreads (UST)	125–175 bp	125–175 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	7.50–8.25%	7.75–8.75%
Rates — Floating	7.40–8.00%	7.05–7.80%
Spreads — Fixed (UST)	150–225 bp	150–200 bp
Spreads — Floating (LIBOR)	125–200 bp	125–200 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	8.25–8.75%	8.75–9.45%
Spreads (UST)	225–275bp	225–275 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.

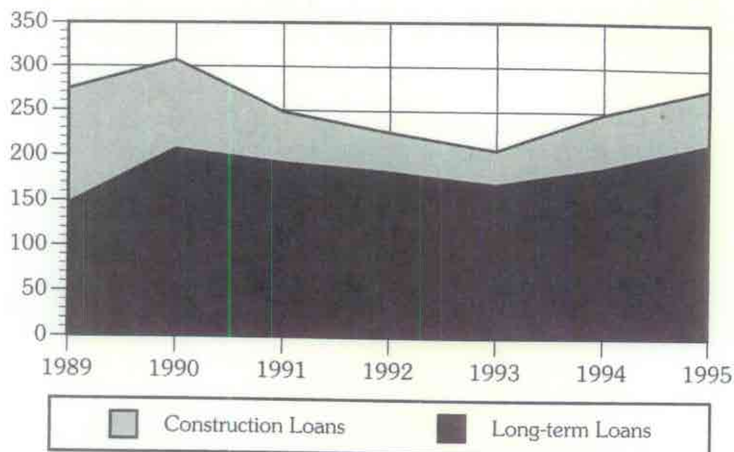
their attention away from some permanent loans, opening opportunities for life companies and pension funds on industrial and multifamily projects, particularly forward commitments. Banks have tended to control new development in these property types, with loan-to-value (LTV) ratios of 75 percent to 80 percent, minimum recourse guarantees at those levels, and interest rates of LIBOR plus 150 to 200 basis points — typically short-term, renewable loans. With LIBOR below comparable Treasury rates, it is difficult to compete with these funds, unless the borrower wants exit guarantees or to avoid hedging expenses. On another front, as real estate values increase, and if interest rates increase further, it could open opportunities for lenders to provide "participating" (kicker) loans once LTV limits are reached and/or debt-service coverage (DSC) ratio minimums are met.

Last quarter in this publication several questions were raised about what to expect in 1996. First, would lenders relax underwriting standards to gain new business? The jury is still out, pending release of the Second Quarter ACLI statistics. Many believe some lenders have done so, whether knowingly, relying on increasing values to protect them, or unknowingly through inexperienced loan officers. With delinquency rates at the lowest levels in 10 years and property values continuing to escalate for most property types, lenders can hope that mistakes are covered by the market.

Next, who will step up and provide funds for the mega-deals in the whole loan market, i.e., loans exceeding $50 million? Life companies have done so, usually joining forces with other life companies, and occasionally pension funds. These loans typically have low LTV ratios, around 50 percent, and low spreads (110 to 120 basis points). Two malls, for example, recently were signed at over $50 million, cross-collateralized, with LTV ratios below 50 percent and spreads below 110 basis points. A major CBD office building is said to be close to signing at around $100 million, 50 percent or less LTV, at less than 110 basis point spreads.

Expect to see this trend continue, although, it will be tough for lenders to do more than a couple of deals in a single market in any one year due to diversification issues. Because of this, the door is open for Wall Street firms. Also, insurance companies have begun to stretch on quality (remember the first question), moving to class "B" real estate on larger cross-collateralized

Private Debt Market Capital Flows



Source: Department of Housing and Urban Development

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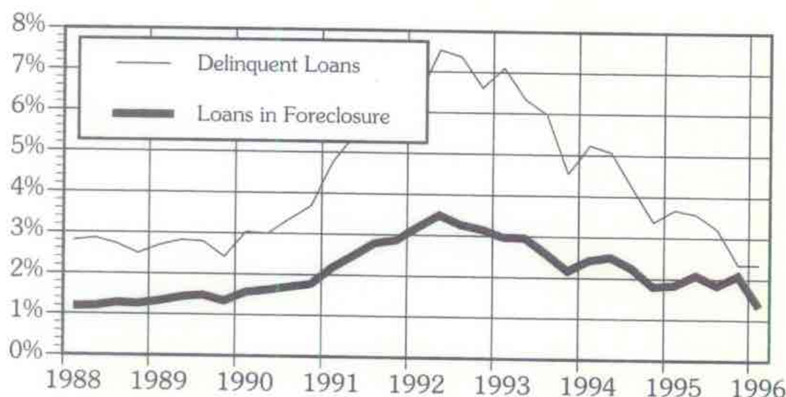
Mortgage Loan Delinquencies and Foreclosures



Source: American Council of Life Insurance

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

	Second Quarter 1996	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	APRIL 8	7.375%	7.500%	7.625%
	MAY 6	7.750%	7.875%	8.000%
	JUNE 3	7.875%	8.000%	8.125%
PRIME MORTGAGE RANGE	APRIL 8	7.500–7.625%	7.625–7.750%	7.750–7.875%
	MAY 6	7.875–8.000%	8.000–8.250%	8.125–8.250%
	JUNE 3	8.000–8.125%	8.125–8.250%	8.250–8.375%
PRIME MORTGAGE RATE	APRIL 8	7.500%	7.625%	7.750%
	MAY 6	7.875%	8.000%	8.125%
	JUNE 3	8.000%	8.125%	8.250%

(For loans $5 million and up)
Source: John B. Levy & Company © 1996

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portfolios in order to improve spreads, (175 to 200 basis points), and put more money to work (over $100 million). The insurance companies will give Wall Street a run for the money, as they don't require lock-boxes and certain "quality of life" issues. But don't count Wall Street out.

The last question regarded the health of the retail sector. Well, retail sales were up and down during the first six months. Cap rates on the other hand moved up. Neighborhood and community centers, and select regional malls, however, maintained their attractiveness to both equity investors and lenders. **"Location, location, location" has been replaced by "location, credit and tenant profitability," as key underwriting focal points.** Cap rates and loan spreads have increased on power centers pending long-awaited credit shake-outs, and perhaps in anticipation of the looming recession predicted by some economists.

Spreads on office and hotels have come down steadily — 130 to 170 and 175 to 225 basis points, respectively.

Spreads on office and hotels have come down steadily — 130 to 170 and 175 to 225 basis points, respectively — as their markets have improved. Multifamily and industrial properties have been, and should continue to be, solid performers. The concern here is with values relative to reproduction costs. There exists the threat of continued development and possible over-building in some markets. We will continue to see new product, especially multifamily, built and/or re-habed, so lenders should be careful on LTV. This is of particular concern in light of continued signs of strong sales of new and existing single-family housing, despite increased interest rates, which could dampen demand and rental rates for multifamily housing.

Rental rates and occupancy affect debt-service coverage and the ability to make payments, the real key to loan underwriting. The LTV ratio is a barometer of whether the borrower has equity and will work to protect it if rents drop. However, some recently released studies on multifamily investment suggest that projected population growth, and consequently job growth, over the next 25 years should maintain demand and equilibrium, so long as development is kept in check, which they believe lenders and developers will do using prudent underwriting standards. Let's hope so. Spreads for both multifamily and industrial properties remain at or below 150 basis points for 75 percent LTV loans. RECMR

Walter Huggins *is a senior vice president of Equitable Real Estate Investment Management, Inc.*

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