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Equitable Real Estate Mortgage Investors

Commercial Mortgage Market Nears Equilibrium

More Institutional Investors Enter Crowded Market

Executive Summary

- **Deal parameters are basically unchanged since last quarter**
- **At spreads of 125-175 bp, commercial mortgages offer better value than corporate bonds**
- **Office and hotel loans offer lenders most attractive returns**

The commercial mortgage market has reached a state of near equilibrium with a significant supply of attractive deals being matched by slightly higher investor demand. As a result of this, market conditions, in terms of deal parameters, have not changed dramatically in several months. **Typical institutional-grade properties can be financed on traditional terms such as 75 percent loan-to-value ("LTV") and 1.2x minimum debt-service-coverage ("DSC") ratios at interest rates of 125 to 175 basis points over Treasuries.**

While these terms essentially are the same as reported in this space last quarter, 10-year Treasury rates fell precipitously during the Second Quarter from 7.10 percent to 6.00 percent at the end of June. Thus, nominal interest rates on typical institutional-quality commercial mortgages today are in the 7.25 percent to 7.75 percent range (although some lenders have minimums of 8.0 percent). These are the lowest nominal commercial mortgage rates since the Third Quarter of 1993 when rates ranged from 7.25 percent to 8.10 percent. On the other hand, note that, as compared to current conditions, Third Quarter 1993 Treasury rates were much lower (5.25 percent to 5.50 percent) and spreads were much higher (200 to 250 basis points).

In addition, underwriting parameters were much tighter then as compared to now. Many lenders were unwilling to lend more than 65 percent LTV, except for quality apartments, which reached as high as 75 percent LTV. Further, most lenders were not even considering office properties at that time, whereas today offices are standard fare for many lenders. As a result of these current factors — i.e., low nominal rates, low spreads and underwriting based upon today's stronger market conditions — borrowers are better positioned now than at any time since the recent real estate downturn.

Nonetheless, from a lender's perspective, the commercial mortgage market continues to offer excellent value. **Given current underwriting standards and fundamental market conditions, most institutional-grade mortgages today arguably would merit a credit quality of "A" to "BBB".** Today, corporate bonds of "A" and "BBB" quality achieve spreads in the 50 to 80 basis point range. At spreads of 125 to 175 basis points, commercial mortgages offer better value than corporate bonds, even after allowing for a 25 to 30 basis point liquidity premium. In addition, in a historical context, today's commercial mortgage market remains attractive. Spreads today average 140 to 150 basis points as compared to approximately 125 basis points over the last 15 years and as low as 80 basis points in the late 1980s.

Institutional investors, particularly pension funds and life companies, continue to enter the already crowded market for high-quality deals. For example, the New York State Teachers Retirement System is in the process of selecting advisor/co-investment partners for separate loan programs targeting small loans ($3 to $15 million) and large loans ($15 to $30 million) with the anticipation

Commercial Mortgage Capital Sources

Lender Requirements*	2Q/94	2Q/95
Insurance Companies/Pension Funds ("A" Quality Real Estate)		
Rates	8.50-9.10%	7.25-7.75%
Spreads (UST)	150-200 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	7.25-9.50%	7.50-8.25%
Floating	6.50-7.25%	7.40-8.00%
Spreads — Fixed (UST)	200-250 bp	150-225 bp
Floating (LIBOR)	150-225 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	9.00-10.00%	8.25-8.75%
Spreads (UST)	225-300 bp	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.

of investing several hundred million dollars in whole loans over the next few years. In addition, the State of New Jersey is also in the early phases of exploring a large commercial mortgage program.

The following are representative recent transactions by major institutional lenders:

Industrial — Southwest Region

A $7.0 million ($36.75/sq. ft.) first mortgage secured by two nearly completed warehouse/distribution buildings, containing over 185,000 square feet, in an established industrial park. The property is in the process of completing its leasing program; it was 50 percent leased at the loan commitment date, 65 percent leased at closing and 90 percent currently. The loan closed with a staged funding tied to lease-up.

Term: 15 years
Amortization: 20 years
Spread: 125 basis points
Coupon: 8.54%
Loan-to-Value: 72%
Debt-Service Coverage: 1.25x

Industrial — Pacific Region

A $13.5 million ($27/sq. ft.) first mortgage secured by three warehouse/distribution facilities, completed in 1990 and comprising 400,000 square feet. The facilities are tilt-up concrete construction with 30-foot clear heights on a total of 22 acres of land. The properties are 100 percent leased to credit tenants on a triple-net basis.

Term: 10 years
Amortization: 30 years
Spread: 190 basis points
Coupon: 8.00%
Loan-to-Value: 67%
Debt-Service Coverage: 1.47x

Retail — Pacific Region

A $7.6 million ($57/sq. ft.) first mortgage secured by a 132,000-square-foot power center built in 1994. The center is 100 percent leased to five credit tenants on leases ranging from nine to 16 years. A 130,000-square-foot, owner-occupied Home Depot is part of the center, although not part of the collateral of the mortgage. The property is located at a key interchange and across from the site of a soon-to-be-constructed regional mall.

Term: 10 years
Amortization: 20 years
Spread: 175 basis points
Coupon: 8.375%
Loan-to-Value: 70%
Debt-Service Coverage: 1.30x

These transactions all are marked by a high degree of principal security in terms of asset quality, LTV, DSC, occupancy and market conditions. In addition, each contain significant call protection in the form of lock-out and yield-maintenance provisions. Generally, lenders have held ground with respect to underwriting issues and have won deals on the basis of spread and fees.

In terms of specific property types, we continue to see excellent value in certain office and hotel loans. Both of these property types are clearly on the upswing, but lagging retail, apartments and industrials. Both in terms of pricing (140 to 200 basis points for offices and 200 to 300 basis points for hotels) and underwriting parameters, offices and hotels can be extremely attractive and should offer excellent risk-adjusted returns. Retail and industrial properties generally are fully priced and should be approached on a selective basis. Finally, we are quite wary of the apartment market, which continues to attract significant investor demand on both a debt and equity basis. Certain apartment markets have grown quite over-heated, particularly in the Southeast. At the same time, well-located, in-fill apartments can be excellent additions to institutional portfolios. RECMR

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

Second Quarter 1995		Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	APRIL 3	8.250%	8.250%	8.250%
	MAY 8	7.875%	7.875%	8.125%
	JUNE 12	7.250%	7.250%	7.375%
PRIME MORTGAGE RANGE	APRIL 3	8.375-8.500%	8.375-8.500%	8.500-8.625%
	MAY 8	8.000-8.125%	8.000-8.125%	8.250-8.375%
	JUNE 12	7.375-7.500%	7.500-7.625%	7.500-7.625%
PRIME MORTGAGE RATE	APRIL 3	8.500%	8.500%	8.625%
	MAY 8	8.125%	8.125%	8.375%
	JUNE 12	7.375%	7.500%	7.625%

(For loans $5 million and up on amortization schedules of 25 to 30 years)
Source: ©1995 Dow Jones & Co.