by
Kurt L. Wright, CFA
Equitable Real Estate

The Tide Has Turned

More Money Available, Borrowers Shop for Terms

After a long and dreary winter, Atlanta is now enjoying what is shaping up to be a very promising Spring. This brings to mind conditions in the commercial mortgage market, where the three-year recession has ended and a potentially prosperous recovery is underway. However, we should take a lesson from that day last March when Atlantans awoke to find nine inches of snow on the ground. Mortgage lenders should not be in a rush to pack up their woolens, or more appropriately, their prudent underwriting standards.

Spreads have come down considerably during the last three to four months for all property types and risk categories.

The market today remains very attractive for both borrowers and lenders, but the balance has shifted somewhat in favor of borrowers. Borrowers are able to achieve up to 75 percent financing on quality properties at low nominal rates (7.75 percent to 8.75 percent on seven- to 10-year deals). Further, with more money and a wider variety of lenders chasing well-secured deals, borrowers are better able to shop for terms that meet their specific needs. The market has evolved from the old "one size fits all" approach to a complex menu of fixed- and floating-rate options.

In an historical context, lenders are still receiving very wide spreads over Treasuries. However, beginning late in 1993 and accelerating during the First Quarter of 1994, more money and new sources of money have emerged. This includes traditional sources such as life insurance companies, as well as a host of new players such as mutual funds and especially the ever-growing list of Wall Street conduits. As a result, spreads have tightened considerably during the last three to four months for all property types and risk categories. At the same time, Treasury rates have risen approximately 100 basis points since the beginning of the year. The net effect is that current mortgage rates are approaching pension fund actuarial return requirements.

Currently, many pension funds are exploring the desirability of the commercial mortgage market but only a few have initiated lending programs. However, the rise in market rates, coupled with pension funds moving up the mortgage learning curve, will result in a significant level of pension fund involvement in the whole-loan market this year. Based only upon the pension funds that are currently expressing a serious interest in the mortgage market, it is reasonable to expect at least $1 billion of new pension fund money to be actively seeking deals by year-end. This will be in the form of both nondiscretionary, single-client accounts as well as discretionary, commingled funds. Generally, pension funds will continue to pursue larger, well-secured loans on "Class A" real estate representing all the major property types. In addition, a few pension funds are willing to lend on smaller properties and riskier concepts.

Commercial Mortgage Capital Sources

Lender Requirements*	1Q/93	1Q/94
Insurance Companies ("A" Quality Real Estate)		
Rates	8.10-9.00%	7.80-8.75%
Spreads (UST)	2.25-2.75 bp	1.75-2.25 bp
Max. Loan-to-Value	65-70%	75%
Min. Debt Service Coverage	1.25x	1.20x
Term	7-10 yrs.	7-10 yrs.
Commercial Banks ("A" Quality Real Estate)		
Rates — Fixed	5.75-8.00%	6.60-8.65%
Floating	5.20-6.50%	4.50-6.00%
Spreads — Fixed (UST)	2.25-2.75 bp	2.00-2.75 bp
Floating (LIBOR)	1.75-2.75 bp	1.75-2.50 bp
Max. Loan-to-Value	65%	75%
Min. Debt Service Coverage	1.25x	1.15x-1.20x
Term	1-5 yrs.	1-5 yrs.
Conduits ("B & C" Quality Real Estate)		
Rates	9.00-9.75%	8.50-10.00%
Spreads (UST)	3.25-3.50 bp	2.50-3.50 bp
Max. Loan-to-Value	70%-75%	75%
Min. Debt Service Coverage	1.30x+	1.25x
Term	5-10 yrs.	5-10 yrs.

* Represents typical transactions, not full range.

Source: Equitable Real Estate Investment Management, Inc.

Debt 1

INCREASED COMPETITION

High-quality apartments remain very hot with all institutional investors, with many lenders financing up to 75 percent loan-to-value (LTV). Today, these LTV ratios are often based upon rather "full" appraisals that reflect capitalization rates ranging

from 8.00 percent to 8.50 percent. Apartment cap rates are now perhaps 50 to 100 basis points lower than just one year ago. This is being driven by a flurry of acquisition activity by real estate investment trusts (REITs), which are currently awash in discretionary capital for apartments. REITs are even looking to new construction in several markets to satisfy their need to put idle cash to work. Apartment lenders should keep a wary eye on these trends and price accordingly. At today's spreads of 175 to 200 basis points over Treasury (fixed-rate basis), quality infill apartments can offer excellent relative value. However, while stringent underwriting is becoming more and more vital, it is not always practiced.

Lower-quality (i.e., "B" and "C" grade) apartments are the darlings of the Wall Street conduits, which are being formed at a dizzying pace. Typical conduit programs extend up to $10 million at 75 percent LTV with a minimum of 1.25x debt service coverage (DSC). Ten-year terms with 25-year amortization schedules are common at spreads ranging from 250 to 350 basis points. There is a good deal of activity today at spreads below 300 basis points. Fees of 1.5 percent to 2.0 percent are standard. Competition for deals is fierce with the second and third generations of conduits struggling to gain a foothold in the market. This will continue to put pressure on spreads and should result in several less competitive apartment conduits dropping out by year-end. Further competition for lower-quality apartment loans is emerging from small and mid-sized life insurance companies as well as a handful of savings and loans (yes, S&Ls!). During the second and third quarters of this year, conduits are expected to offer investors a very full plate of new issue commercial mortgage-backed securities. This will be the first true test of the longer-term viability of the conduit industry.

The increased competition for deals has spread to the office market, which one year ago was all but off-limits. Lenders are very willing to bid on Class A office buildings with credit tenants on leases which extend past the term of the mortgage. Typical terms include up to 65 percent to 70 percent LTV ratios, a minimum of 1.20x DSC, heavy amortization and escrows for taxes and near-term tenant improvement capital. Spreads on these deals range from 175 to 225 basis points with most deals being quoted at around

— *Continued on next page*

REITs are even looking to new construction in several markets to satisfy their need to put idle cash to work.

Fawsett, Patrick & Co.

Ambassadors for Institutional Real Estate, Inc.

Fawsett, Patrick & Co.
9603 North 100th Street
Scottsdale, Arizona 85258

Robert H. Fawsett
Michael E. Patrick

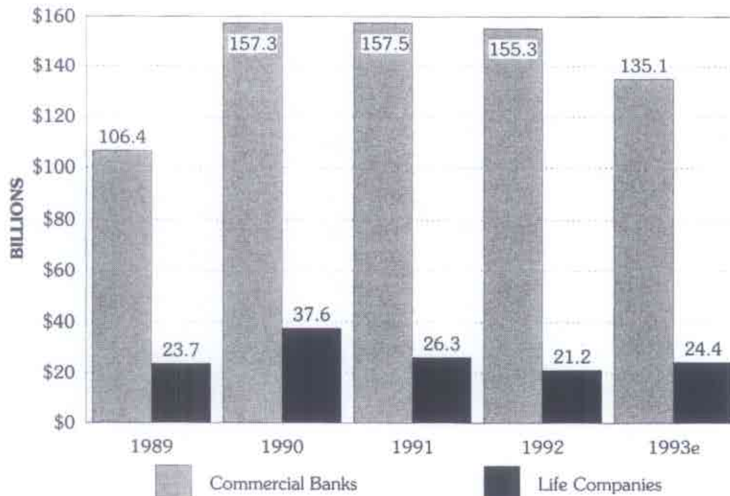
TEL (602)661-0448 FAX (602)391-1701

GLEESON
REALTY ADVISORS

A multifamily investment advisor with $300 million under management invested in 8,000 apartment units nationwide.

12221 Merit Drive, Ste 1415
Dallas, Texas 75251
214 458-0099

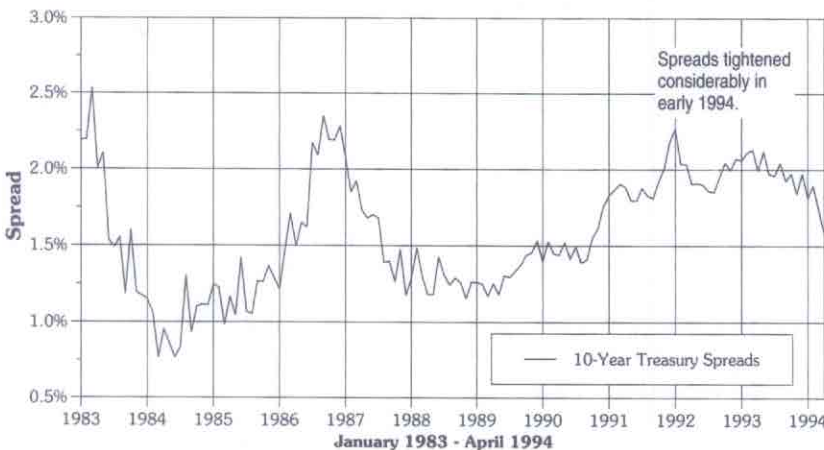
Originations of Commercial Mortgage Loans



Source: U.S. Department of Housing and Urban Development *e: estimated*

Debt 2

Barron's/Levy National Mortgage Survey Spreads



Source: ©1994 Dow Jones & Co.

Debt 3

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

	First Quarter 1994	Term of Loan 25-30 year amortization schedule, 0-1 points		
		5 Years	7 Years	10 Years
LOW	JANUARY 10	6.750%	6.875%	7.250%
	FEBRUARY 7	6.250%	6.750%	7.250%
	FEBRUARY 28	7.00%	7.25%	7.625%
PRIME MORTGAGE RANGE	JANUARY 10	7.125-7.375%	7.250-7.500%	7.625-7.750%
	FEBRUARY 7	6.875-7.000%	7.125-7.250%	7.500-7.750%
	FEBRUARY 28	7.375-7.625%	7.500-7.750%	7.875-8.000%
PRIME MORTGAGE RATE	JANUARY 10	7.125%	7.250%	7.625%
	FEBRUARY 7	7.000%	7.125%	7.625%
	FEBRUARY 28	7.500%	7.625%	7.875%

Source: ©1994 Dow Jones & Co.

Debt 4

200 basis points. For more plain vanilla, multi-tenant offices and for deals with moderate amortization, demand still remains fairly tepid with spreads ranging from 225 to 275 basis points. To date, lenders have not been willing to relax underwriting standards for offices, but instead have won deals by cutting spread (which further improves DSC) or capping the borrower's fees and expenses.

Demand is very strong for smaller retail, particularly anchored community centers and certain power centers. Small to mid-sized life insurance companies are in heated competition for deals of $10 million and less, with new lenders constantly entering the market. Some conduits have established warehousing lines of credit for retail product and will become active over the next several months. However, life companies have recently firmed up their competitive position with the advent of "Schedule D" lending. Life companies can reduce spreads by as much as 25 to 50 basis points on loans that meet NAIC requirements for bond accounting treatment, (which carries a lower reserve requirement than a standard mortgage).

Large ($40 million and greater), well-positioned retail properties are highly sought after by institutional lenders. In addition, regional malls are often prime candidates for single asset securitizations. As a result, these deals are difficult to find on a whole-loan basis. Spreads for traditional deals at 65 percent LTV ratios are in the 150 to 175 basis point range, and can drop as low as 135 basis points for low LTV deals (e.g. 50 percent LTV). In terms of relative value, there is still a great deal to be found on new centers in the $10-30 million range. This includes power centers and power/strip centers of recent vintage as well as to-be-built opportunities. For existing centers, spreads of 200 to 225 basis points are common. Normally, spreads increase by approximately 50 to 75 basis points for 12- to 18-month forward commitments on to-be-built projects.

Mid-size deals (i.e. $10 to $50 million) of all major property types should present good value for some time to come since this is one segment that Wall Street hasn't quite figured out how to securitize in a production-line fashion. RECMR

***Kurt Wright** is a vice president and portfolio manager in the investment capital group of Equitable Real Estate Investment Management, Inc.*