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How to Beat the Big Freeze

When credit markets thaw again, you should be prepared to crack them wide open

ALTHOUGH U.S. CONSUMERS HAVE YET to feel the full impact of a stabilizing economy, the capital markets and lending system have begun to show improvement.

Government programs such as the Troubled Asset Relief Program (T.A.R.P.) and the Term Asset-Backed Securities Loan Facility (TALF) are playing a role in this stabilization. As banks and lenders start to feel more comfortable lending on commercial real estate again, the frozen credit market will show signs of thawing out.

Commercial mortgage brokers who understand the challenges, as well as what factors must come into play to thaw the market, will be well-positioned to help their business and their clients' businesses prepare for the comeback. Here's what you should know.

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In recent years, the credit markets were virtually frozen, and institutions refused to lend to one another. Today, interbank lending has stabilized, and commercial paper rates, Libor rates and TED spreads — i.e., the difference between three-month Treasury and three-month Libor rates — have improved year to year.

Credit spreads for 10-year AAA securities dropped from their highs of 1,500 in fall 2008 to around 525 this past September, according to Trepp LLC. The fact that spreads have come in is one indicator that the credit markets have settled.

Despite these positive signs, there still is turmoil in capital markets. Lending institutions continue to tighten their basic lending standards. In addition, several large national banks have left the market altogether because they've been more impacted by toxic assets than smaller local

and regional banks, which weren't as active from 2005 to '07.

In fact, with less competition and the ability to make conservative loans to strong borrowers, several local and regional players have moved into the national lending arena. These smaller players can compete and earn returns with strong balance between risk and return.

Many of these smaller banks are relatively new to commercial real estate lending, however, and are still learning the business. This adds a new dimension to the process and increases borrowers' difficulties, and it is one of many challenges facing the commercial mortgage industry today.

The government also is sending mixed signals to the industry. On one hand, the Federal Reserve Board is trying to infuse liquidity into the market and encourage lenders to extend capital to investors. On the other hand, it is discouraging commercial banks from entering the market because of concerns about their ability to make quality investments effectively.

The federal government also remains concerned about relinquishing its control over the capital markets. Looking back at one of the instigators of this troublesome market — mortgage-backed securities — the government recognizes that lack of regulation allowed many institutions to make loans with little perception of risk. Lenders generally believed that strong property fundamentals achieved from '05 to '07 would continue. Clearly, they have not.

Lender concerns abound

Lenders still are dealing with issues relating to the commercial real estate market. These issues, as mortgage brokers likely know, are affecting lenders' underwriting



Illustration: Dennis Wunsch

guidelines and lending decisions.

Lenders' questions and concerns include:

- 1. Where should interest rates be,** given the risk in the market?
- 2. Generally, property fundamentals** continue to erode nationwide.
- 3. Values are foggy** at best, as the market is producing few data points to support underwriting and support confidence.

Maturing debt also will present challenges to the commercial mortgage market. A glut of debt will come due in the next few years, with the peak expected in 2012. In 2010 and 2011, maturing debt is expected

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to exceed \$800 billion, according to The Real Estate Roundtable. The market is concerned that this wave of debt will cause a double-dip recession.

There doesn't appear to be a clear solution to that problem right now. Fortunately, banks have started to turn substantial profits in this market because of the profit margins on their cost of funds. Over time, these profits may allow banks to repair their balance sheets enough to deal with some of the toxic assets. Lack of balance-sheet strength has, in many instances, forced banks to be patient in extending mortgages and working with borrowers facing problems.

The government also likely will be part of the resolution by providing additional resources to help with this wave of maturing mortgage debt.

Stage set for recovery

What separates this economic downturn from others is the lack of construction across all property types nationwide. In this cycle, developers did not ramp up construction in most major areas.

In general, development came to a halt a number of years ago. As such, there is limited new product coming to market. Therefore, in some markets, there has not been a supply-demand imbalance as seen in previous recessionary periods — a factor that likely will help recovery.

Also, the unprecedented level of government intervention that began with the creation of T.A.R.P. in '08 will continue to give the commercial real estate market a much-needed boost. T.A.R.P. certainly helped repair balance sheets of participating banks. Banks aren't going to lend and use their multipliers to enhance capital if they don't feel comfortable about the future.

In addition, TALF has shown signs of jump-starting the commercial mortgage-backed securities (CMBS) market, which has been virtually nonexistent for two years. Some major CMBS issuances are ready to come to market, but the level does not compare to the levels seen from '05 to '07.

When AAA securities can be financed,

yields can be enhanced. This will attract investors to the market despite perceived risks. Through TALF, the Fed is effectively adjusting the risk-return relationship to lure big investors into acquiring mortgage products. In essence, that will be the key to jump-starting the CMBS market.

Although there has been some improvement in the banking and lending business, bankers are continuing to avoid making aggressive loans. Consumers are having problems, and the national unemployment rate has reached a 26-year high. Further, short-term real estate fundamentals are eroding and property values are uncertain, which means it's not the best time to provide debt capital.

Clearly, all active debt-providers have adopted a conservative approach to financing commercial real estate. They are lending on better-quality assets and scrutinizing each transaction. Lenders are looking for strong sponsorship. Generally, they want to see a property with historical operations that support tenant demand in a primary market.

Lenders are cautiously selective in their financing approach. An owner with a small strip mall in a tertiary market will have problems, regardless of whether banks have money to lend. Lenders typically are looking for well-located, class-A or -B properties that will retain their long-term value.

Finding comfort

Ultimately, there are four factors that must come to fruition before lenders begin providing capital on a large scale to commercial real estate borrowers:

1. **The employment market** must stabilize and trend positive.
2. **Consumer confidence** must return.
3. **Tenants must feel confident** moving back into buildings.
4. **Property fundamentals** must stabilize and eventually improve.

Despite near-term challenges, there are signs that the economy has begun to stabilize. Payrolls were relatively lean heading into the current downturn. As of early

October, the economy had shed about 7.2 million jobs since the recession began in December '07, according to the U.S. Bureau of Labor Statistics. As such, many businesses may need to rehire workers somewhat quickly when an economic recovery gains traction. Because of that, the commercial real estate market could experience a relatively swift increase in demand for space when compared to other recovery periods.

Productivity rates are increasing, and many companies have been able to reduce expenses significantly in recent quarters. Consequently, companies are well-positioned to record strong profit growth when the economy rebounds. With the unemployment rate at 10.2 percent this past October and expected to grow, there will be plenty of slack in the economy. This will limit wage and pricing pressures as a recovery takes shape, reducing inflation concerns in the near term.

Overall, businesses should be able to expand somewhat rapidly when demand for goods and services accelerates.

Finally, during the most recent period of economic expansion, there was minimal overbuilding in the commercial real estate sector as compared to previous periods, outside of retail. Through at least 2010, weakened commercial real estate fundamentals and tight credit markets will cause many developers to defer or abandon many projects in the pipeline. This will hamper the pace of new projects entering the planning phases. Property owners likely will have an opportunity to lease existing vacant space ahead of the next construction cycle.

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To help their clients understand which way to turn in the coming year, brokers should understand the factors that led to the lack of financing in today's market. They also should know those factors that will help spur lending again.

With this knowledge, you'll be ready for the market turnaround when it comes. ●