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Credit crunch squeezes commercial real estate

GUEST COLUMN

Dennis Pellecchia

In the wake of tighter credit requirements in the home-mortgage market, commercial real estate borrowers are finding themselves in the midst of a credit crunch of their own. After enjoying the lowest rates in 40 years, commercial borrowers are facing more stringent underwriting requirements and the near extinction of interest-only deals.

The change in the commercial real estate lending climate hit suddenly last summer, leaving leveraged investors scrambling and the market in general competing in a more costly and cautious credit climate. According to real estate investment bank Buchanan Street Partners, commercial borrowers are now experiencing reduced proceeds, stricter underwriting standards, less-aggressive loan structures, and greater scrutiny of business plans and cash flow scenarios.

In other words, commercial borrowers face a new reality in financing fundamentals.

NO MORE CHEAP DEBT

As recently as last year, commercial investors could finance 85 to 90 percent of a property with a five- or 10-year, interest-only loan. Lenders, eager to compete aggressively for market share, were willing to underwrite deals with high loan-to-value ratios in anticipation of rent increases and projected future income levels. Debt-service coverage ratios dipped as low as 1.0 for many, and some lenders offered loans that didn't even meet that break-even point.

But all that changed in a matter of weeks as concerns about floundering home mortgages spilled over into the commercial realm. By late June 2007 fixed commercial-mortgage rates rose an average of 50 to 75 basis points, to approach 7 percent. Debt service also climbed, as borrowers were required to pay principal plus interest. By July, deals were falling through as investors simply couldn't get the leverage they needed.

Credit rating company Fitch Ratings warned in a July 2007 report that defaults on commercial mortgage-backed securities were likely to rise for the first time since 2003 due to overly aggressive lending conditions over the past two years. With rents lagging such expectations, increased defaults seem likely.

COMMERCIAL SKY ISN'T FALLING

The bright side is the commercial-loan market isn't expected to experience the kind of pain the subprime segment has suffered. Rather, lenders are sizing up borrowers and their deals more cautiously. Lenders have returned to underwriting loans based on current – and not projected – cash flow from actual tenants.

Additionally, certain segments are inherently less risky than others and are still thriving in the current environment. Multifamily housing may be a safe haven, along with some office properties in hot areas, such as Los Angeles or Seattle. Lenders may also open their pocketbooks for projects such as medical-office facilities located close to hospitals.

TIME TO STRATEGIZE FOR THE FUTURE

The commercial-mortgage credit crunch is not expected to loosen as the year wears on. Tom DeSimone, executive vice president of W.S. Development Associates LLC, one of Boston's major real estate developers, recently observed: " … in the third and fourth quarters of last year, the experts felt the situation would start to correct itself in early 2008, but it has not happened. The $260 billion commercial-mortgage-backed securities market (CMBS) may not reach $50 billion in 2008, meaning that there is a significant decline in capacity. The question then becomes how is the $210 billion shortfall in capacity made whole again? Sure, some of these loans shouldn't be made but even if that amounts to $100 billion, the market is still short over $100 billion. Many life insurance companies have greatly reduced their capacity and lending staffs and can now simply buy mortgage-backed securities at great yields without the so-called "brain damage" of underwriting and servicing a mortgage loan portfolio. The banks have stepped in to some extent, but they are under pressure from their subprime and residential lending to add capital, thereby limiting their capacity.

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In the meantime, if you are a commercial real estate investor you can still increase the value of your holdings through existing properties. Work with your accountant or adviser to develop a sound real estate strategy that may not include new property purchases, but instead investments in existing properties via improvements, leasing, redevelopment, aggressive management and expense control.

There is money to be lent, and those that have widened the lens are seeking funding from on-book lenders – commercial banks, savings and loans, and life insurance companies – that plan to hold loans on their balance sheets. Meeting requirements for financing that involves selling loans to investors in the secondary market is difficult in the current market, particularly for smaller or midsize investors.

To cope with today's tighter credit market, commercial real estate investors and developers can expect lenders to:

- Require additional equity for a real estate purchase or development. The maximum leverage will likely be 70 percent to 75 percent of the purchase price.
- Offer extremely limited interest-only periods for permanent loans. TIP: Expect to qualify only if in the 50 percent loan to value category.
- Be unwilling to fund speculative projects based on projected rental numbers. TIP: Line up preleasing agreements before seeking a mortgage.
- Require a business plan with a clear exit plan. ■

Dennis Pellechia is chairman of the board and director of real estate practice at Braver PC, a Newton, Mass.-based accounting firm with an office in Providence.

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