TMO NEWS

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SQUARE FEET

COMMERCIAL LENDERS TAKE STEP INTO RISKIER DEALS

BY JULIE SATOW

K. C. Conway, executive managing director a at Colliers International, says many investors want hard assets.

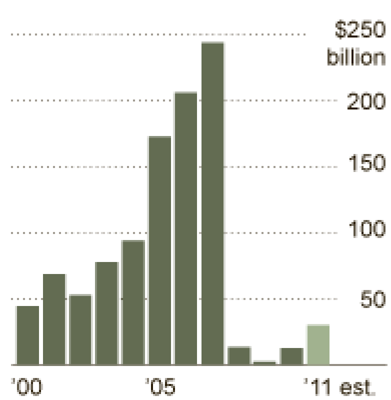
The market for commercial real estate loans is coming back, but already some industry professionals are warning that risky practices that were common in the recent boom are returning.

An increasing number of financial institutions are vying to make loans on commercial real estate now. But many buildings are still drowning under heavy debt loads, leaving few properties that can support new borrowing. This means that banks, insurance companies, hedge funds and others are competing fiercely to underwrite the few viable loans that are available. Because of the competition, some lenders have begun to compromise their underwriting standards, say ratings agencies and market professionals.

“We are deeply concerned,” said Tad Philipp, the director of commercial real estate research for Moody’s Investors Service. “Underwriting standards have gone from very good in 2010, to just O.K. this year, and we want to make sure they don’t drift into risky territory.”

Gaining Steam

Trepp, a private analytics company, expects $30 billion in commercial mortgage-backed securities to be issued this year.



Source: Trepp LLC THE NEW YORK TIMES

Commercial loans are big business. At the peak of the market, in 2007, commercial mortgage-backed securities, which are bonds backed by pools of commercial real estate loans, were a $243 billion market, according to the research company Trepp. The market then stalled and reached a nadir in 2009 with only $2.4 billion in issuance. The market began to thaw last year and 12 deals totaling $12.6 billion were completed. Most of the loans underwritten last year consisted of top properties in prime markets, where there was very little risk of default.

This year, the deals have picked up significantly. So far, there have been 16 deals for $16.8 billion, Trepp said. Some of these deals include properties in Oklahoma and Kansas, and even hard-hit markets like Florida and California. Some of the assets are also less stable, with lenders underwriting deals for mobile home parks and self-storage units.

At the same time, metrics used to judge possible defaults are indicating more risk. Increasingly, appraisers are taking into consideration higher future rents and occupancy rates, rather than using only current figures. Inflated appraisals were common during the market peak but disappeared after the crash. There are also more interest-only loans, where the borrower pays interest on the loan but does not pay down the principal, with a large balloon payment due at the end of the term.

Appraisers say their figures are not inflated, but rather reflect the improving market in some areas of the country. “It is important to point out that commercial real estate is a two-tier market: there are distressed properties and markets and premier properties and markets,” said Leslie Sellers, the 2010 president of the Appraisal Institute, an industry group that has more than 24,000 members. Appraisers are accounting for a rosier future in only those top-tier markets, he said. “If we didn’t do that, we would be remiss.”

A sharp increase in the number of commercial real estate lenders is mostly driving the surge in mortgage-backed securities. Large banks like Bank of America, Citigroup and Goldman Sachs have resurrected their commercial mortgage-backed securities, also known as C.M.B.S., lending again after the downturn, while new players have also entered the market, like Cantor Fitzgerald and the hedge fund giant Citadel.

“Banks need to generate earnings, but they aren’t underwriting many new mortgages or other loans, so securitization is a very attractive option,” said K. C. Conway, the executive managing director of real estate analytics at Colliers International.

Insurance companies and foreign investors are also lending as they look to rotate into hard assets and out of cash and other investments that are vulnerable to inflation, Mr. Conway said. In the search for hard assets, the commercial real estate market is attractive because it is widely perceived to have bottomed out.

Yet there are only a relatively small number of properties that are not highly leveraged and in a position to borrow funds. According to Trepp, over one trillion dollars’ worth of commercial real estate loans due in the next five years are still underwater, meaning the market value of the properties is less than their debt.

“It is the classic scenario of too many dollars chasing too few deals,” said Peter J. Mignone, a partner at the New York office of the law firm SNR Denton.

With so few opportunities, lenders are facing multiple pressures. To create bonds, they must pool together several commercial loans, but with so few strong borrowers, “their only choice is to leave the primary markets and look to the secondary and even tertiary markets to fill up these loan pools,” said Lawrence J. Longua, a clinical associate professor at the Schack Institute of Real Estate at New York University.

At the same time, these lenders have built infrastructure and need to put their capital to work. “A critical mass is needed to justify the C.M.B.S. platforms they have built, so they may be willing to look at making riskier loans if that is what is available,” Mr. Longua said.

So far, the deals being underwritten today are consistent with the types of deals seen in 2004, according to research by Moody’s. That year “was one of the last normalized years before the aggressive underwriting began to ramp up,” Mr. Philipp said, “so we are right at the inflection point.”

Underwriters are also coming up with novel structures. For example, in a deal led by Deutsche Bank and UBS, the management of the Crystal Gateway Marriott in Virginia is set to receive a fee if it meets certain profit requirements.

While this so-called incentive management fee is not striking on its own, it is to be paid first, ahead of the debt service. Standard & Poor’s called this “highly unusual” in a recent research note.

There are have also been several commercial mortgage-backed securities deals underwritten in the past year where the leases expire before the loans come due.

This leaves the buildings vulnerable to the possibility of losing rental income. At 7 Hanover Square in lower Manhattan, for example, the Guardian Life Insurance Company of America occupies nearly the entire building, and its lease expires in 2019, but the loan does not come due until 2021.

A loan for 660 Madison Avenue has a similar structure. The building is fully occupied by Barneys New York, but its lease expires 18 months before the loan matures. In addition, Standard & Poor’s has a low rating for the company and says it is as risk of a downgrade.

“If lenders are going to be aggressive, there should be a really good reason, and not just to win a lending assignment,” Mr. Mignone said. “If you have a few lenders who choose to be aggressive, then their competitors’ only alternatives are to also be aggressive or to close their checkbooks. This is when you risk having a race to the bottom.”

But while there are examples of eroding underwriting standards, more safety measures now exist than before the downturn. For example, there are more interest-only loans, but many are for short periods and not the entire life of the loan.

And while some leases expire before the bonds mature, many include safety provisions like agreements with tenants to renew their leases or requirements to post letters of credit as collateral.

“On balance, it is true that the deals are less conservative now, but as a result, we are on the path to do $30 billion in C.M.B.S. deals this year, versus just $12 billion,” said Thomas A. Fink, a senior vice president and managing director at Trepp.

Still, said Barbara Duka, a managing director at Standard & Poor’s, “what has surprised us is the speed at which the metrics have gone from very conservative to much less so.”