Low Levels of Interest

Refinancing Concerns Surface, as CMBS Retrenches and Maturities Loom

By Keat Foong

Beginning in late summer, the nascent U.S. recovery appeared to stumble perilously. Obama signed austerity into law after a much publicized debt ceiling "crisis." The stock market plunged. Days later, Standard & Poor's Corp. downgraded the U.S. government debt. Meanwhile, the Greek and Euro-zone sovereign debt problems wore on and intensified. Treasuries continued their slide. And there was a "flight to quality" on the part of investors.

These events have had little deleterious effect on interest rates in the commercial real estate world, but that hardly matters in the face of larger issues. "The real issue has to do more with underwriting than interest rates. We could put interest rates at zero, and it won't make any difference," commented K.C. Conway, MAI, CRE, executive managing director of real estate analytics for Colliers International.

The various crises are very much to blame for refinancing difficulties, reversing any progress made in opening up capital flows to middle-market assets in secondary and tertiary markets. At issue is the retrenchment of the CMBS market, which has seen investor pullback in response to the economic hazards in the United States and abroad. In August, the CMBS market received another significant hit on confidence when Standard & Poor's withdrew its ratings on a $1.5 billion issuance by Goldman Sachs and Citigroup. Subsequent issuances in early fall were not very encouraging, as investors reportedly refused to purchase the B pieces. Consequently, issuers were striving to restructure the securitizations with less risk and higher returns. As of now, CMBS lending either has stopped or is at least very limited, according to lenders.

"Certainly, CMBS is an important part of the market and an important source of capital. To the extent that market is operating at less than full speed, it raises the question about the availability of capital for some loans at some prices," agreed Jamie Woodwell, vice president of commercial and multi-family research at the Mortgage Bankers Association.

The biggest impact will be on borrowers with Class B and C properties in non-core markets, who may have to wait a little longer for capital to return to their markets. Lenders may once more be venturing back to core assets and locations. And players are again becoming more concerned about the capital markets' ability to refinance commercial real estate loans that will mature in the next few years.

With CMBS out of the market, banks and life companies will have to pick up the slack—if they can. According to Clay Sublett, senior vice president & CMBS manager with KeyBank Real Estate Capital, interest rates for financing provided by banks and life companies have remained "surprisingly stable" through the turmoil, as have those for Fannie Mae, Freddie Mac and FHA financing for multi-family properties.

Life company debt, in particular, continues to be "very aggressively priced," said Sublett, with interest rates of 4 to 4.5 percent for the right product. Life company loans are not as volatile because they are not tied to the securities markets, he explained. "Since they are lending their own money, (the interest rates) are based on their internal cost of funds. They pride themselves on the stability of interest rates."

These debt sources tend to lend only on the top properties, however, and maximum LTVs are 65 percent. Thus, the sub-institutional-quality transactions that CMBS financing traditionally picks up remain underserved. Life insurance companies receive so many applications that they can afford to be very picky, said Sublett. They are extending debt only to Class A, A-minus or B-plus properties and prefer locations in the larger markets. Sublett cited the example of an unanchored retail property located in the greater Seattle area that in the summer could obtain quotes from only two life insurance companies—out of about 65 in the market.

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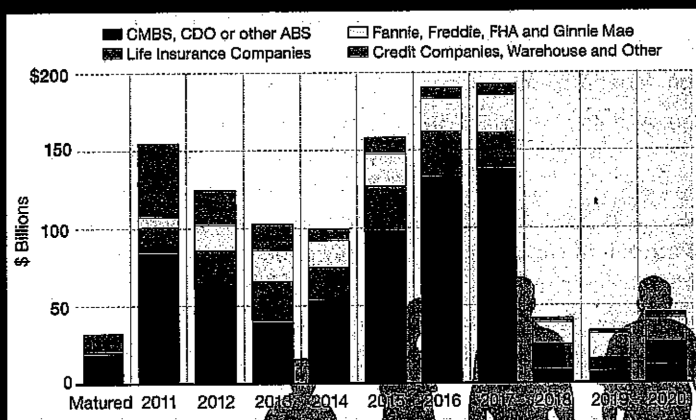
On the bank side, interest rates offered also continue to be "very competitive," said Sublett. Interest rates for variable-rate bank refinancing loans have increased by only about 20 basis points to a spread of 200 to 250 basis points over LIBOR. Rates are in the low-5 percent range for fixed-rate recourse financing, with maximum LTVs at about 75 percent.

Bank of the West is an example of a bank that is actively seeking to make loans, and interest rates have remained low and stable for the bank's debt financing programs. "Federal economic policies have led to a historically low Treasury rate, and the abundance of liquidity from el-

evated personal and corporate saving rates has helped keep our cost of capital down, and we are able to extend this benefit to our clients," said Erik Nelson, senior vice president & group head of small and medium enterprises construction lending.

Also helping to keep interest rates down are the low levels of the benchmark rates, which have stayed depressed despite the market volatility—or because of it. LIBOR has remained "unprecedentedly low" as an index for construction lending, said Nelson. And for fixed-rate loans, the 10-year Treasuries and swap benchmarks have also been very favorable over the past two years. At the same time, loans spreads are compressing in the banking sector, as banks seek out and bid for the most viable opportunities in commercial real estate, he said. "Economic conditions are generally fragile, but we still see opportunities in all of our markets."

Three years ago, Bank of the West strategically targeted small and midsize businesses as a key market segment for growth for both lending and non-lending products. Under its recently launched refinancing/acquisition financing campaign for small loans of up to $2 million secured by owner-occupied commercial real estate, the bank offers interest rates of 5.39 percent for its 20-year, fully amortizing fixed-rate loans, and 4.35 percent for its five-year, 25-year amortizing fixed-rate loans.



Source: Mortgage Bankers Association

As in the case of bank and life company financing, interest rates for CMBS loans also did not spike dramatically. "Overall, CMBS interest rates crept up, but not by as much as you would think," said Sublett. CMBS spreads widened, from between 200 and 250 basis points to 350 basis points by September. However, at the same time, the 10-year Treasury swap rate dropped by about 20 basis points, to remain in the low 2 percent range. Consequently, all-in CMBS rates increased by about 50 to 75 basis points, from the mid-5 percent range to 6 to 6.5 percent, with a maximum LTV of 70 percent.

Although the overall CMBS rates of 6 to 6.5 were still relatively low, the sudden widening of the spreads for CMBS financing may have scared off borrowers. "Most CMBS lenders were quoting in the 6, 6.25 percent range. Historically, it is still a very good rate, but if you look at just the spread over the Treasury swap, there has been a dramatic increase," said Joseph Franzetti, senior vice president of Berkadia. As a result, unless they had an absolute maturity issue, borrowers were putting off refinancing, he said. The fear was that with volatility in the markets, "lenders would not be there at the end of the day to deliver. Borrowers were afraid that they might find at closing that the loan is not $10 million but $6 million."

During times of financial crises, CMBS lenders price in wider spreads. Spreads are also wider because a lot of CMBS investors were spooked by leverage and underwriting issues, said Franzetti. "The type of investors buying CMBS 2.0 tend to be money that moves faster," intensifying the volatility, he added. Many of the loans that were part of securitizations queued up in September were not profitable, having been originated when spreads were much tighter, Sublett added.

By October, CMBS lending had already ground to a halt, said Colliers' Conway. "(Originators) will complete existing deals, but I do not know anyone who is taking new applications or soliciting new loans for CMBS." Conway says that CMBS originators are now trying to "clear the deck" and securitize existing product if possible, even at a loss, in advance of the release of the Dodd-Frank regulations. Section 165 in particular will extend certain regulations to "non-bank financial institutions." And the players, notably insurance companies, are waiting to see if the definition of "systemically significant" institutions will be applied to them and do not want to be left holding CMBS loans for now, he explained.

As a result of the new difficulties in CMBS financing, concern has resurfaced about the capital market's ability to refinance the commercial real estate debt that is maturing in the next few years. "There are no two ways about it: If you do not have normally functioning capital markets, there is no place (for those loans) to go other than loan modification, default—and someone loses a lot of money in the process. There is no solution other than capital returning or the economy improving," said Franzetti.

According to the MBA, $124.5 billion worth of commercial loans will mature in 2012. If it is any consolation, the annual commercial real estate loan maturity volume will not be peaking yet; it will drop between 2011 and 2014 before picking up again in 2015-2017, as 10-year loans executed in 2005 and 2007 come due then.

For now, for a borrower holding a less-than-Class A quality property that is not in a major market and that had originally obtained 75 percent financing, "generally, we say, talk to your local bank and maintain good working relations with your local banker, because there is not a very good execution for that property right now," said Sublett. CPE