Grubb & Ellis
Property Solutions Worldwide

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Commercial Real Estate and the Sub-prime Lending Crisis

Executive Summary:

- Purchase money debt for commercial transactions has been impacted:
  -In the Conduit market, up to 100 basis points have been added to the cost of commercial credit in the past few weeks. The Commercial Mortgage Backed Securities (CMBS) segment accounts for approximately 20% of debt in commercial deals.
  - Funds originating from insurance companies, pension funds, and banks that do NOT sell their debt in the marketplace are being re-priced; these funds are still available.
- The economy overall is still strong. The Fed seems poised to use its significant power to stem this looming crisis in an effort to avoid a sustained downturn in the economy.
- Cap rates will likely rise 25 to 50 basis points by the fourth quarter of ‘07.
- Spreads will likely settle around 160 in the 4th quarter of ’07.
- All commercial lenders are actively reviewing their lending criteria to assure they will not fall into the “sub-prime mess” that has been so disastrous to residential lenders. The commercial lenders are reviewing policies on interest only loans, size of down payments, loan constants, appraising policies, and due diligence requirements.

A hot topic on the wires and throughout the trenches of commercial real estate is the impact of the sub-prime and debt markets on commercial real estate deals. The bottom line, based on Grubb & Ellis broker feedback, is that the credit markets are having a negative impact on the industry. Spreads have been widening during 2007, however, the collapse of the sub-prime lending market and chaos in the commercial debt obligations market has brought the issue to the forefront, and over the past month there has been a paradigm shift in how credit risk is priced. Deals in the works that require the debt to be sold in the financial markets are being thoroughly scrutinized, and often re-traded in an attempt to widen the lender spread. Transactions fortunate enough to have locked rates, (e.g., Insurance Company Debt), are largely unaffected.

To date, the market is still flush with investors looking to place capital. There is no shortage of funds available; it simply costs more. Pension funds and private investors coming out of 1031 exchanges have been unaffected. For those requiring significant leverage, lenders are becoming more stringent, requiring more due diligence and larger down payments. This is resulting in re-trading, as well as longer closing periods as lenders review deals more thoroughly. There is a slight disconnect between buyers and sellers, as low cap rates are less attractive with the cost of funds having increased. Spreads have shifted by 80-110 basis points and are now at around 200 in many markets, up from 100 or so a few weeks ago. The fact that the shift has occurred over the past six months is positive, in that a correction of 50 basis points had already occurred in the private equity market, making the current situation less of a shock to many private buyers and sellers. As a whole, class A product is still moving, and balance sheet lenders (pension funds, insurance companies) are still active, but Commercial Mortgage Backed Securities deals, which accounted for 21% of all commercial real estate debt last year (per *Emerging Trends*), are not getting done. Class B & C properties are also feeling more of an impact. Lower quality properties had been enjoying similar underwriting to Class A portfolios in recent months, pricing of these properties is now being scrutinized more closely.

From a more macro view, the market has been mixed, with the failure of multiple large sub-prime lenders creating volatility and uncertainty in the market. On the other hand, Fannie Mae & Freddie Mac, two federally backed mortgage lenders, reversed from their decline last week, signaling the market's belief that federal regulators will ease investment limits on the home-loan finance giants as a way to pump cash into the struggling mortgage market. In addition, bank stocks, which have been hammered by the subprime crisis, have seen significant recovery over the past week as investors seek quality banks, which pay generous dividends and have little exposure to the sub-prime market.

There is some consensus among experts in regards to the real estate side of the equation. In regards to the overall economy, many feel that when all is said and done this episode will be a blip on the radar in an overall positive market. It may take six months for the markets to find a new equilibrium level and slightly longer than that for Wall Street to clear the committed but non-securitized debt (totaling $200-300 billion) off its books. Cap rates overall can be expected to rise 25-50 bps (per Wachovia). One lagging factor is the housing market, which is unlikely to regain its composure for at least another year as foreclosures reach a peak later this year and extend into 2009 (per Moody’s Economy.com). Some investors may re-price shopping centers due to a mounting concern over consumer spending trends. The verdict on apartments is mixed, with some thinking that the housing slump is a net plus as more households are forced to or choose to rent (NMHC), while others think the hit to the supply side from unsold condos and foreclosed houses outweighs any benefits on the demand side. Office, industrial and hotels are less affected. **In short, lenders still need to lend dollars to make money, and many large investors still have money to place in real estate**.

Some deals will not close. The spread may rise a bit more during the third quarter, but will likely come back down, to perhaps 160 basis points or so, with the caveat that underwriting will be more stringent after this point. We have likely seen the end of no-down loans. The temporary pricing disconnect between buyers and sellers will last 6-12 months. In reality, the cost of debt is still near all time lows, as are mortgage and interest rates. The economy is fueling a healthy demand in the real estate market, making long-term investments still a good buy. In comparison to other asset classes, **real estate will remain a good buy** because rents continue to firm or rise or even spike in a growing number of markets.

A larger unknown is the impact on the greater economy. There is a strong possibility that the economy will get through this without a recession on the strength of global demand and the business sector, while consumers take a breather from shouldering the growth cycle. It’s the scenario that economists have been predicting for years – business capital spending becomes the lead engine while consumers pull back – with some unexpected drama added to the mix in the form of a looming credit crunch. Overall, the consensus at this point seems to be that it’s a needed correction that will return some measure of sanity to pricing in financial markets, of which real estate is a part. While it could devolve into a full-blown crunch, that seems not to be the most likely scenario. The sub-prime crisis may be causing an over correction in the credit market, which will in turn see a decline in rates to an equilibrium level. Other market fundamentals remain positive, including jobs, stocks and corporate profits. In addition, the likelihood of the Fed cutting rates has increased significantly. Case in point, on Friday August 13, 2007 the Fed added reserves three separate times, bringing the daily injection of funds to $38 billion, the largest amount of liquidity since the days after the September 11th attacks. This is an indication the Fed is taking pro-active measures to ensure financial stability.

As with any sea change of the market, there are opportunities out there. Cash buyers or buyers with secure sources of funds will find that many competitors may be priced out of some markets,

making the competition for deals slightly less chaotic. For those investors still standing, there will be less real estate investment risk in the long term as supply and demand will return as the primary valuation factor for deals. For many buyers, the changing state of the market means that sitting on the sidelines for a few weeks or months may result in a better deal, at lower rates and with a faster close than is possible in the current market. For sellers trying to close on existing deals, it may be a good idea to close now to lock in at current pricing levels, as prices are likely to decrease slightly, especially on deals that are strictly upside or value-add plays. Many see October first as a potential turning point, as a significant number of the adjustable rate mortgages will adjust on this date with the potential risk of more volatility if the default rate increases from the current 15 percent for sub-primes after this shift. As the initial firestorm of uncertainty burns over, solid real estate and credit-worthy buyers will continue to create opportunities for profitable transactions on a solid footing.

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