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FINANCIAL DIGEST

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The current commercial mortgage market

The reports I study and the professionals that I speak with all indicate that commercial real estate markets are improving, albeit slowly. The statistics all generally support that position. The apartment market has improved generating the greatest demand among buyers and lenders with new apartment construction occurring in many areas. Even office market vacancy rates have been steadily declining, although nominally.

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Interest rates are still predicted to remain low through the end of 2013 as assured by Fed Chairman Bernanke. Right now the benchmark 10 year U.S. Treasury has remained well below 2 percent for close to two months and at one point was just above 1.4 percent. That bodes well for the commercial mortgage market but how will all of this impact maturing loans, especially, CMBS loans, written in the last five to ten years?

The Trepp organization recently predicted that approximately $1.7 trillion of CMBS loans will mature between now and 2017 with $360 billion due this year. Said $1.7 trillion does not include the "on book" portfolio loans maturing at banks and insurance companies. The problem impacting how CMBS loans may be refinanced was created in 2008 when foreign investors lost confidence in American real estate backed mortgage securities and stopped investing. What had become the single largest source of mortgage money in the United States that over supplied the mortgage markets substantially dried up. A modest rebound, referred to as CMBS II, began late last summer.

Unfortunately, there is not enough mortgage money in all of the banks and insurance companies combined, even with the re-emerging CMBS II potentially closing as much $100 billion this year, to fully supply the CMBS refinancing demand.

In an environment of over demand and under supply, mortgage lenders can "pick and choose" which loans they want to fund while imposing tighter underwriting standards. We have witnessed that since 2009. While becoming a little more liberal, that underwriting trend will continue for some time. Low interest rates and more liberal underwriting standards will undoubtedly benefit many properties but they can't overcome the real problem for many CMBS borrowers.

The commercial real estate markets are simply not improving fast enough to restore their values to prior levels. Their current loan to value ratios are 70, 75 or even 80 percent, (in some cases 100 percent or more) of their current appraised values. Often, their original loans were 80 percent of a somewhat overly optimistic value exacerbating the problem. While they may be able to pay their current debt service, even with less than 90 percent occupancy, and with rents that are lower than a few years ago, they cannot readily refinance enough at today's standards when their loans mature.

The Special Servicers of many CMBS loans, when a loan is in real or technical default (e.g. higher than 75-80 percent LTV, not maintaining a 1.25 debt service coverage factor, etc.) or when a loan has matured (often with some real equity) move to foreclose as there usually is no justification to extend or restructure a loan in such circumstance. Defaulted CMBS borrowers have few options:

• Sell, recognize little or no equity, possibly even take a loss, pay gains and recapture taxes and move on

• Inject additional capital to reduce the debt (themselves or by adding a partner) to current re-financeable levels and re-finance.

• Some (but very few) are able to reduce the debt enough and provide sufficient reserves to have the loan restructured by the Special Servicer

• Allow the foreclosure and the "lender", in many cases the lowest tranche holding CMBS bondholders, loses their investment. They really are the individuals or entities that are losing and absorbing the "deltas" between debt and value. For tax purposes the amount of debt owed effectively becomes the "sale price". Tax is owed with no sale proceeds to pay them

• Find a newly formed fund to "partner" with to solve the pending tax and future capital needs problem.

Disposition of these CMBS maturing loans has been referred to as a "potential tidal wave of default." The solutions are varied and will take a long time to work through the market although there are opportunities at many levels for active commercial mortgage market practitioners to benefit.

Accordingly, if you are seeking a re-finance you need to make sure that your proposal (real estate collateral, occupancy, equity, sponsorship LTV ratio and similar) are aligned with current lender requirements.

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