

Bernanke's Easing Thwarted by Surging Commercial Mortgage Rates

By Bob Ivry

Jan. 25 (Bloomberg) -- Federal Reserve Chairman Ben S. Bernanke is proving powerless to prevent a deteriorating commercial real estate market.

While the yield on 10-year Treasury notes fell 1.43 percentage points in the past three months to the lowest since 2003 following four interest rate cuts, the cost of borrowing for apartment buildings, offices, retail properties and hotels climbed as much as 1.25 percentage points, according to David McLain, principal and chief investment officer of Palisades Financial LLC, a private equity firm in Fort Lee, New Jersey.

"The market is locked up right now because there's a huge overhang of leveraged assets of every type, development deals that won't meet projections made last year when things were rosy," said David Tobin, a principal at New York-based Mission Capital Advisors LLC, which was involved in \$5 billion of asset sales last year. "It will end just like the residential housing market."

Bernanke's easing hasn't stopped the \$3.2 trillion commercial market from starting a slide that mirrors the housing decline, where prices have dropped for the first time since the Great Depression. U.S. commercial property prices probably will fall 10 percent in 2008 from last year's peak after rising 60 percent since 2002, said Dan Fasulo, director of market analysis at New York-based research firm Real Capital Analytics Inc.

Late Payments

Delinquencies of securitized commercial mortgages may quadruple in the next 18 months to almost 4 percent, said Kenneth Rosen, an economist at University of California, Berkeley, who runs a real estate hedge fund. About 70 percent of commercial mortgages are pooled into commercial mortgage-backed securities that are sold to investors, Rosen said.

Commercial loan rates are based on spreads, or the difference between the amount of money CMBS promise to pay investors over what the 10-year Treasury bill will pay.

Different parts of the mortgage have varying prices depending on the risk profiles of the individual slices of the security. The first part of the loan is priced in correlation with the highest-rated, or AAA, piece of the security, said Scott A. Singer, executive vice president of New York-based Singer & Bassuk Organization, which arranges financing for property sales. The rest of the mortgage costs more because it's based on the other, riskier pieces, he

said.

The spread for a security's AAA tranche widened to 125 basis points, or 1.25 percentage points, on Jan. 16 from 26 basis points a year earlier, data compiled by Morgan Stanley show.

Debt Service

Yields for the B-rated slice, five risk levels below AAA, grew to 1,400 basis points, or 14 percentage points, above the Treasury bill, and averaged 901 basis points in the past year, Morgan Stanley said.

A buyer could borrow \$1 billion -- not unheard of in the New York City market -- a year ago and expect to pay annual debt service of \$58 million, Singer said. Today that same mortgage would have an annual cost of \$76 million, he said.

``That's assuming you can find the money," Singer said. ``It's much harder now than it was a year ago."

The yield has widened partly because banks have tightened their bond-secured lending, according to a Jan. 11 report from JPMorgan Chase & Co. analysts in New York.

Wall Street underwriters allowed lending guidelines to slacken because they needed the mortgages to feed the \$760 billion market for securities backed by commercial mortgages, said Scott Tross, a mortgage specialist and partner at the Herrick, Feinstein LLP law firm in Newark, New Jersey.

Feed the Market

``Lending standards became more lax because people knew they wouldn't be keeping the loans on their books," Tross said.

Moody's Investors Service, a unit of New York-based Moody's Corp., warned in April of a steady erosion in underwriting quality, and Standard & Poor's, a unit of New York-based McGraw-Hill Cos., said the vast majority of commercial mortgages in new bonds required payment of interest only, without any reduction in the loan's principal.

Lenders responded. According to the Fed's Senior Loan Officer Survey, published in October, half the banks surveyed made loans more difficult to obtain in the third quarter of 2007.

The average down payment lenders required rose to 23 percent of the purchase price in the fourth quarter, the highest in three years, from 19 percent in the second quarter, according to New York-based Merrill Lynch & Co. analysts Roger V. Lehman and Julia Tcherkassova.

Loan Securitization

The number of new commercial mortgage-backed securities, which help fund loans, dropped 54 percent in the fourth quarter from a year earlier, data compiled by industry newsletter Commercial Mortgage Alert in Hoboken, New

Jersey, show.

Lehman Brothers Holdings Inc. analysts predict a more than 50 percent drop in CMBS issuance in 2008, making mortgages even tougher to get.

``If banks can't securitize the loans, they won't make them," Tross said. ``There will be loans coming up for maturity that will be difficult to replace."

Manhattan real estate investor Harry Macklowe, owner of the General Motors Building at 59th Street and Fifth Avenue, hired CB Richard Ellis Inc., the world's largest commercial broker, to find new investors or a buyer for the building as he tries to repay a \$7 billion debt by Feb. 9.

Ian Bruce Eichner, a New York developer who lost two buildings to creditors in the 1990s, defaulted on a \$760 million loan from Deutsche Bank AG last week for his Cosmopolitan Resort & Casino on the Las Vegas Strip. Deutsche Bank will continue to pay for construction while Eichner negotiates a new deal, according to Perini Corp., the project's general contractor.

South Korea to U.K.

Centro Properties Group, the Glen Waverley, Australia-based owner of U.S. malls, is struggling to refinance A\$3.9 billion (\$3.4 billion) of debt. Investors have wiped out 92 percent of the company's market value since Dec. 12. Two-thirds of Centro's A\$26.6 billion of shopping centers under management are in the U.S.

In the U.K., Jones Lang LaSalle Inc., the world's second-largest commercial real estate broker, estimates transactions fell 60 percent during the last three months of 2007 to about 5 billion pounds (\$9.8 billion).

Commercial real estate isn't slumping everywhere. South Korea's New Songdo City, a 1,500-acre (607-hectare), \$30 billion city that's being built from scratch, has received financing from a trio of South Korean banks, South Korean steelmaker Posco and New York-based Morgan Stanley Real Estate, said John B. Hynes III, chief executive officer of New York-based Gale International, the project's developer.

Japan Prices

In Japan, land prices rose last year for the first time since 1991 and sales of commercial mortgage-backed securities probably increased 18 percent, said Douglas Smith, managing director of commercial real estate at Deutsche Bank.

``Japan is the only functioning market globally for CMBS," Smith said last month. In the U.S., ``not many deals are being done and the European market is essentially shut down."

Lenders that supply the so-called second-tier, or mezzanine, financing, were charging about 11 percent a year ago in the U.S. due to competition from large, international banks, McLain said.

Now the bigger banks have dropped out, leaving the field to companies such

as McLain's Palisades Financial private equity firm, which have a higher cost of funds and charge as much as 5 percentage points more than they did last year for the same loan, he said.

`` That cheap money is gone," McLain said. `` Almost overnight, we're in the game."

No `Liar Loans'

The effects of aggressive lending are apparent in a Long Island, New York, retail center that's about 90 percent built, McLain said.

Underwriters for the project estimated rents in the 60,000 square foot mall of more than \$30 a square foot, McLain said. McLain's projection, based on actual retail rents in the area, was about half that.

The mortgage on the property is \$6 million, McLain said. Palisades Financial will bid \$2.8 million, he said.

While lenders on both the commercial and residential sides have been aggressive in the past five years as property values climbed, there are differences between the two.

In 2006, almost half of all subprime home loans, available to borrowers with bad or incomplete credit, required no documentation of income, according to data compiled by Zurich-based Credit Suisse Group. No-doc, or ``liar loans" as they're called, don't exist in the commercial arena.

About \$190 billion of subprime home loans will reset in 2008 to a higher interest rate, Credit Suisse reported. Commercial loans have fixed rates and usually cover 10-year periods.

Commercial borrowers also have a higher level of experience, Lehman analysts said in a Dec. 12 report.

Linked Markets

`` Yes, they did take full advantage of the easy availability of leverage and at times have been over-optimistic about future cash flow streams from properties," the report said. `` But they are more sophisticated than subprime borrowers, usually with an understanding of what they are getting into and with significant equity at stake."

The retail and commercial real estate markets are linked, and they are both at the mercy of turmoil in global credit, said Michelle Meyer, a Lehman Brothers economist in New York.

`` Housing weakness is likely to lead to a weaker commercial real estate market because fewer houses mean demand for shopping and schools will decline," Meyer said. `` The credit problems take it beyond the usual cyclical swings."

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