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# Subprime meltdown: Commercial market singed

## Rising borrowing costs are starting to burn non-residential real estate

**By Frank Byrt**
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The problems in the residential mortgage finance sector are now taking a toll on the availability and terms of financing in the commercial real estate market, which raises the specter of weakening resale prices, something that was unimaginable in the red-hot property-flipping market of just a few months ago.

That's because the problems uncovered in the residential mortgage market meltdown have become too big for investors to ignore, so they're cutting back on the whole real estate sector, including their use of commercial mortgage-backed securities (CMBS), which is what lenders rely on to get their loans to developers off their balance sheets.

As a result, the CMBS market has been hit by a double whammy: skittish investors cutting back on purchases and a glut of supply because of the record $137 billion in CMBS issued in the first half of this year as private equity and institutional money flooded into the commercial property market.

Because of those factors, the cost of borrowing is up as yield spreads, the difference between the yield on CMBS and the yield on comparable-maturity Treasuries, have widened significantly in the past few weeks.

"The overall negative pricing impact on commercial mortgage spreads has been about 20 to 25 basis points on 10-year fixed-rate mortgages," Jones Lang LaSalle, a real estate services company, said in a research report last week. "The greater concern has been our increased difficulty in obtaining debt quotes; when quotes are available, the spreads are often significantly wider than recent experience."

In the past few weeks, as the drumbeat of problems in the residential mortgage market has picked up, so has the lack of confidence in the CMBS market. "The market for debt financing for commercial properties got smaller and it has repriced, making it more difficult and expensive to put a deal together," said Jere Lucey of Jones Lang LaSalle real estate investment banking group in New York.

So buyers are going to have to work harder to find a lender, and they'll have to put up more collateral and pay more in interest, despite the fact that the sector is showing some of its strongest economic fundamentals in years, with delinquency and foreclosure rates at historic lows.

James Calvano, chairman of Palisades Financial, a private equity firm that is also involved in commercial real estate lending, said, "It's mostly anecdotal at this point, but we hear that its becoming more difficult (for REITs and others) to finance deals, and if that occurs it will put pressure on the whole category."

Jeremy Glaser, a Morningstar REIT analyst, said the volatility in those markets may be playing a role in the postponement of the planned Tishman Speyer Properties/Lehman Brothers $15.2 billion acquisition of the Archstone-Smith Trust apartment REIT originally scheduled to close this month. Now it's been put off until October. "They gave no specifics, but I believe the banks are finding it harder to take on the debt from deals like this as it becomes more difficult to place it in the form of CMBS."

One fresh example of that came from CBRE Realty Finance, a commercial real estate lender, which said in releasing second-quarter results last week that it is suspending new investments “given the recent volatility in the capital markets. The current credit market environment is unstable and the company continues to review and analyze the impact on its potential avenues of liquidity.”

So the next question hanging in the air is whether the gathering uncertainties are enough to cause a retreat in commercial property values. Views on that are mixed.

Mr. Lucey said it’s tough to say where prices will go, because for one thing, there’s still a lot of capital looking for a home, and commercial real estate remains appealing. “I don’t think this [CMBS market dislocation] is saying to people that prices are wrong. I think it is saying risk wasn’t accurately priced and that in certain instances mistakes were made in underwriting.”

While Cushman & Wakefield’s global head of capital markets, Tom MacManus, said he’s not seeing an immediate impact, he thinks prices may weaken as a side effect of the rising cost of capital because there will be fewer eligible bidders on properties than have been seen over the past few years and therefore less aggressive bidding.

David Tobin, a principal at Mission Capital Advisors in New York, said, “Investors are beginning to take the view that property prices will not continue to appreciate like they’ve appreciated over the past several years.”

And that, coupled with the higher cost of financing, means their returns will be weaker. “Those two changes in the assumptions used in valuation models are definitely going to throttle the commercial market.” **FW**

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