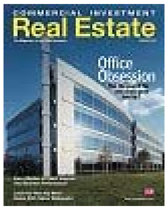


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# 7 Real Estate Finance Myths Unveiled

Discover the market factors that really are influencing today's transactions.
By Andrew Stewart

Much of the real estate finance industry operates on dogma, most of which is grounded in sound theory about the factors that drive commercial real estate markets and risk pricing. During the past 15 years there have been significant advances in methods for assessing and quantifying risk, which contribute to more disciplined debt and equity investors.

However, many of the risk models and decisions taking place in commercial real estate today are based on assumptions that are questionable. Understanding the reality behind some of these myths is important when making commercial real estate financing decisions.

**Myth No. 1: Real estate equity currently is a safe haven for investors.** In the long term, well-located real estate is a solid investment. However, the short and intermediate outlooks are somewhat more clouded. The idea that today's valuations will be maintained is a risky proposition. Since 1993 real estate values in this country have performed well in most markets due to a confluence of factors that have made real estate a favorable asset class. This long bull market must end at some point.

For instance, if a property owner places two advertisements for the same property -- one for lease and the other for sale -- there might be a deluge of interested buyers, but far fewer potential tenants. Something is wrong with this phenomenon, since investors buy real estate for its long-term cash flow potential. If interest rates rise, values will decline, with much of the downward pressure being caused by floating rate loans that cannot be refinanced or cannot carry their debt service. And, inevitably, capitalization rates will rise back to historical levels.

**Myth No. 2: Spreads on commercial mortgages are too low.** Many commercial mortgage debt investors are complaining that they are not being fairly compensated for risk. But this is only partially true. Investors that receive 90 basis points over U.S. Treasuries for a truly conservative mortgage are being fairly compensated, since many of those loans have an extremely low probability of ever defaulting. In actuality, 90 basis points is a fair yield as it is a 22 percent yield increase over a 4.1 percent treasury. When bonds were 8.82 percent on average in 1988 and low leverage spreads were at 90 basis points, the reward for investing in a mortgage was a 10.2 percent premium over the risk-free rate. Note that 80 percent loan-to-value loans were between Treasury plus 175 and 200 basis points in 1988; now they are Treasury plus 110 to 140 basis points for most properties.

Complaints regarding spreads for highly leveraged loans, where debt investors are attempting to get an additional 30 or 40 basis points of yield, are justified. In these instances, the lender is taking on an inordinate amount of risk for the incremental yield offered in today's market.

**Myth No. 3: Mortgage debt is a solid investment right now.** While lower leverage loans are just fine in the current market, higher leverage mortgages are mispricing risk. A commonly used term these days is debt cap rate, which generally refers to the mortgage amount as a function of the cash flow. Often times the debt cap rate reflects a loan amount that is more than the property would have sold for a few years ago. In many cases, traditional lending tenets are being tossed aside.

Experts know that studying real estate markets' history is a poor way to predict future performance. Subordination levels are in sharp contrast compared to levels a few years ago. Commercial mortgage-backed securities originators are touting the new "super senior structures" of their issues. This structure carves out a junior piece of AAA bonds backed by mortgages that are subordinate to the rest of the AAA tranches. In theory, the balance of the AAAs is safer. However, this thinking would be sound if AAAs didn't continue to take a growing share of the entire mortgage pool; all this does is recover some of the ground lost by more-lenient subordination levels. The rating agencies and many bond buyers are confusing theory with reality, causing errors in judgment.

**Myth No. 4: Liquidity will continue to exist.** Many investors wrongly assume that capital, both debt and equity, will continue to be consistently available. More typical credit cycles have longer periods where liquidity is scarce, such as the cycle that occurred between 1990 and 1993.

Real estate fundamentals are stronger now than in 1988-1989, which greatly reduces

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the chance of a near-term liquidity squeeze. It is likely, however, that in a few years there will be a lower supply of available credit, especially for leveraged transactions. Refinance risk for loans originated now is higher than at any time since 1986-1989. This is true for leveraged fixed rates as well as interest-only floating rates.

Collateralized debt obligations, or CDOs, which have continued their transformation into a core asset class in the fixed-income markets, currently incorporate pooled B financing pieces from CMBS into their offerings. CDOs are complex securities, even for bond investors, as they contain numerous types of credits including home equities, corporate credits, and high-yield loans. Since CMBS B pieces comprised only 6.98 percent of total 2004 collateralized debt issuances, it is possible that the risk inherent in B pieces is not fully understood. There is a trend towards dedicated real estate CDOs comprised of aggregated subordinate debt and mezzanine investments. The idea that pools of unrated securities can have investment-grade tranches seems counterintuitive despite the fact that diversification of the pooled B pieces somewhat neutralizes their risk. Many of the buyers of B pieces are now less concerned about risk so long as they can transfer it to collateralized debt buyers. If B piece liquidity through collateralized debt originations diminishes, then leveraged loan supply will follow suit.

**Myth No. 5: All conduits are the same.** Many investors believe that all conduit financing is similar in price and structure, but this is not true. In case you haven't noticed, conduits are staffed by people, and so are the rating agencies and bond buyers. This means that anyone originating or selling mortgages have their own subset of experiences from which to draw upon. There are startling differences between securitized lenders in how risk is viewed, structured, and priced. One needs to truly understand what is happening with numerous players in this market to achieve efficient execution.

**Myth No. 6: Interest rates must rise soon.** This is not as certain as some people seem to think. A popular belief among economists and others is that we have been living off the dole of the Federal Reserve Board for too long. The U.S. economy has yet to establish the kind of job growth that drives gross domestic product to levels that cause the Fed to raise rates dramatically. Hurricane Katrina may also have an impact on federal policy in the near term, causing them to pause in their current round of rate increases.

Inflation appears to be in check assuming that recent oil spikes do not contribute to a spiral of price increases the way they did in the 1970s. The largest financiers of the federal deficit, Japan and China, which hold more than $1.2 trillion of U.S. debt, cannot liquidate their positions without experiencing an enormous bond value loss. This is because the market likely would panic if the industry suspected that either entity wanted to reduce its U.S. Treasury holdings. The Fed also should realize that disastrous consequences could occur if it raises rates too fast. Consumers are financing much of their spending through home equity borrowing. This would collapse if rates rose quickly, which also would deflate home prices to the extent that the solvency of Fannie Mae and other large investors in adjustable rate residential and commercial mortgages would be at risk.

**Myth No. 7: The real estate bubble will burst soon.** It is possible, but not if rates stay close to current levels. Since rents in many markets have been somewhat depressed for a while, it is possible that rent inflation will increase as some markets reach equilibrium. For instance, it is hard to imagine that class A suburban office rents can drop much more than current levels. Very little supply has been added in areas that are supply constrained due to lack of available land or soft leasing. Better information flow regarding absorption has enabled construction lenders to enforce greater supply financing restrictions. If rents recover in certain areas, there is upside value potential.

To navigate the current market, equity investors should tread water carefully and debt investors need to be wary of leveraged loans based upon inflated asset values. Existing borrowers should lock in as much money as their investments can support for as long as possible -- more than 10 years is preferable. If owners have another method of deploying capital outside of real estate, it is time to sell, but not to buy more real estate at inflated values.