

## **CREDIT ILLIQUIDITY DOWNSTREAM EFFECTS ON COMMERCIAL REAL ESTATE**

There has been a sudden deterioration in the real estate credit markets which has resulted in numerous escrowed deals being delayed, re-negotiated or terminated. This rapid impairment to the credit market was recently caused by the subprime mortgage fall-out, rising residential and commercial foreclosure levels and the dramatic decrease in homebuilding sales. All levels of debt have been affected and the re-pricing of risk levels in the broader capital markets has begun.

In an unanticipated move, the Fed lowered the discount rate by 50 basis points on August 17, 2007. This was done to contain the credit illiquidity cause by the subprime collapse and to keep the economic expansion at the desired levels. Many economists also think the Fed acted to stabilize a deteriorating banking system. The banks have been hurt by the housing slump, increasing foreclosures, subprime mortgage problems and the resulting credit crunch.

The preliminary affects on commercial real estate debt are less aggressive loan underwriting practices including lower loan-to-value (LTV) ratios, higher loan spreads (145-175 basis points over treasuries) and the curbing or elimination of interest only periods. Nationwide, the commercial mortgage backed securities (CMBS) market has seen a curtailment of fixed rate loans, lower tolerances for sub AA rated debt and limited liquidity. Locally, smaller borrowers will likely see less available lending for speculative transactions, higher interest rate spreads and lowers LTV's.

Most deals that were in the application process or approved are reportedly being honored, albeit with some re-negotiations. Bear Sterns, which recently saw nearly total collapses of two of its multi-billion dollar hedge funds, has walked away from approved loans with "paid" interest rate locks, without reimbursement.

Commercial real estate loan transactions in the D/FW area have largely remained unaffected as the recent declines in the 10-year Treasuries have offset the widening rate spreads. The underlying fundamentals of commercial real estate continue to stay at healthy levels of supply and demand. These two factors have so far prevented a significant adverse "spill over" from the subprime residential mortgage crisis and homebuilding declines to the commercial real estate debt market.

However, many observers predict all commercial real estate levels to be re-priced due to the anticipation of further widening interest rate spreads, fewer equity participation/mezzanine loan opportunities and increasing capitalization rates. Strong borrowers can expect an increased cost of debt, weak borrowers can expect a dwindling number of options. Real estate prices should see an immediate stabilization of appreciation and experience declines in overbuilt sectors. Over leveraged property owners and under-capitalized transactions will see increasing scrutiny in the loan underwriting process during re-financing or deposition of their assets.