

MBA

## A Noisy End to the 'Perfect Calm'

Disruptions in global capital markets spill into commercial real estate, but savvy investors take action. **By Jamie Woodwell**

In a January 2007 article in *Mortgage Banking* magazine, we characterized the commercial/multifamily real estate finance market as being in a state of "perfect calm." Improving property markets, strong capital markets and innovations all combined to create new records for the industry. Originations, mortgage debt outstanding and property prices hit new highs, while cap rates and loan and bond delinquencies fell to new lows.

The question wasn't if the "perfect calm" would end, but when and how. The recent capital markets disruptions answered that question for now. As concerns about single-family housing spilled over into other capital markets, the flow of capital slowed and strained some of the recent innovations in the capital markets.

The result was a big increase in the spreads investors were demanding to invest in commercial mortgage-backed securities and a slowdown in CMBS loan originations. Because CMBS accounted for about 46% of commercial/multifamily originations in 2006, the capital markets slowdown affected the entire market.

But the disruption raises a new question: What is the real impact? To be clear, the commercial/multifamily markets still remain in exceptional shape. Property

performance has generally remained solid, with indicators showing continued growth, and commercial loan and bond performance remains remarkably strong.

Even the rating agencies have been relatively upbeat. "There are few signs at this time of imminent credit distress that would lead to a spike in delinquencies or downgrades in the commercial mortgage sector, largely thanks to strong property market fundamentals," says Tad Philipp, managing director at Moody's.

During August and September, rating agencies upgraded 8.5 times more CMBS issues than they downgraded. As of the middle of October, CMBS spreads started to narrow slightly and capital appeared to be coming back to the CMBS markets.

### Good news or bad news?

A key challenge in this period of transition is that most of the data investors will be considering describes a market already disappearing in the rear view mirror. For example, the MBA's third-quarter mortgage originations data will be released halfway through the fourth quarter.

Another key challenge of leaving a period of such exceptional performance is that every change is magnified. According to Wachovia Capital Markets and Intex

Solutions, for example, at the end of June the delinquency rate for commercial/multifamily loans in CMBS was approximately 0.3%. One year ago the rate was 0.6%, and two years ago it was 1.07%.

Delinquency rates are almost certain to rise from these historically low levels. But as they rise, there will be much "noise" about deteriorating loan performance, even though by historical standards delinquencies will likely remain quite low.

Similarly, sales and origination volumes are likely to decline in coming quarters. How could they not? Recent numbers have included the sales, resales, financings and refinancings of the \$39 billion Equity Office Properties portfolio, the \$7 billion CNL Hotels portfolio and many others. In 2006 alone, Real Capital Analytics tracked 31 announcements of sales of properties or portfolios that exceeded \$1 billion.

But as sales revert to a "new normal," there will be a great deal of attention paid to the declines in the sales and finance markets, even though by historical standards they will likely remain quite robust.

### Capitalizing on turbulence

Indeed periods of transition tend to provide exceptional opportunities. As the industry shifts from one gear to another — finding its "new normal" — that normal will be determined by individual investors transacting individual deals.

As usual, investors with sharp pencils and knowledge of their own markets and investment objectives will find opportunities. Those who can focus on long-term relative value, and cut through the vibrations of short-term market changes, will enjoy the fruits of those opportunities. The new normal is coming, and value investors will know it when they see it. ■



Jamie Woodwell serves as the senior director of commercial/multifamily research with the Mortgage Bankers Association based in Washington, D.C..

### CMBS SPREADS REFLECT MARKET JITTERS

AAA CMBS spreads spiked nearly 45 basis points between June and August of this year amid a credit crunch. In 1998, a credit crunch ensnared hedge fund Long-Term Capital Management, causing an even bigger spike.



Source: Morgan Stanley