THE Perfect Calm

Three prevailing fronts currently lingering over the commercial/multifamily real estate markets have created close to ideal conditions.

BY JAMES R. WOODWELL

In Sebastian Junger's account of the sinking of the *Andrea Gail* in his book *The Perfect Storm,* he describes how three separate weather systems merged off the northeastern coast of North America and, through their combined force, caused a "perfect storm." This particular storm roiled the seas as few others have. The commercial/multifamily real estate industry also is currently experiencing the effects of three powerful forces. But unlike Junger's perfect storm, these three forces have merged to create a perfect calm—an environment in which commercial/multifamily real estate markets have been smooth and balanced. As with any weather report, what lies over the horizon is open to speculation, but for the time being the skies are clear and the waters are smooth for the commercial/multifamily finance industry.

The three factors driving today's commercial/multifamily finance climate are widely available capital, steadily improving property markets and innovations in real estate finance markets. In recent years these combined factors have led the industry to record origination volumes, record levels of mortgage debt outstanding, record property values and, happily, record loan performance.

And while each front carries its own power to calm the markets, the combined force of all three has led to a period of unparalleled production and stability.

The first, and most powerful, of the forces bringing calm to the commercial/multifamily markets is the unprecedented availability of capital.

Front 1: Availability of capital

The first, and most powerful, of the forces bringing calm to the commercial/multifamily markets is the unprecedented availability of capital.

Between 2000 and 2005, U.S. credit markets absorbed $14 trillion (that's with a "t") in additional investment, rising 52 percent to $41 trillion. The flow of capital has come from both international and domestic sources.

According to the Federal Reserve, between 2000 and 2005, holdings of U.S. Treasuries increased by 39 percent, with holdings by non-U.S. investors (including governments) rising by 95 percent. Holdings of agency and government-sponsored enterprise–backed (GSE-backed) securities rose by 44 percent, with holdings by non-U.S. investors rising by 116 percent.

Holdings of corporate and foreign bonds (in which residential and commercial mortgage-backed securities [MBS] are included) rose by 75 percent, with holdings by non-U.S. investors rising by 116 percent. The demand from domestic and, particularly, foreign investors has driven a massive flow of capital to U.S. credit markets.

The results of this unparalleled availability of capital (and demand for investment vehicles) have been the same as the effects in any market that sees a powerful surge in demand. Whether measured by the rates of Treasury securities or spreads on commercial mortgage-backed securities (CMBS) and other instruments, the demand for investment vehicles has pushed prices up and yields down. This flow of capital has helped to keep long-term rates relatively low, and has been a major force in the continued inversion of the yield curve.

The flow of capital—along with recent economic growth—has helped to depress credit spreads as well, narrowing the difference between yields on highly rated (AAA) and other securities. After climbing to 215 basis points at the end of 2002, corporate credit spreads as reported by New York–based Standard and Poor's began to drop, falling to 58 basis points in January 2005. These spreads, more recently, have risen only slightly, to 93 basis points, in September 2006 (see Figure 1).

Allocations to commercial/multifamily

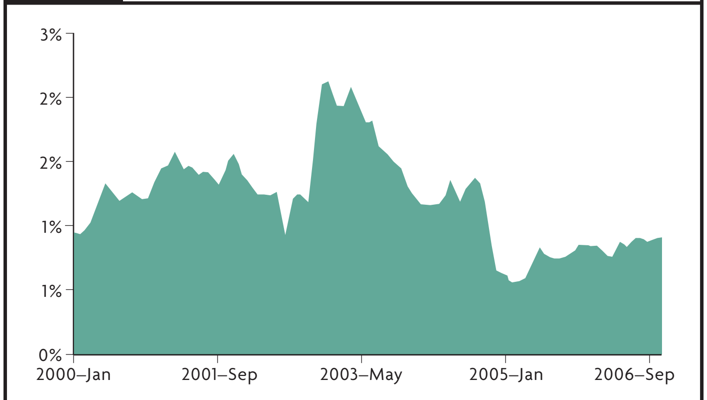
But among this rising tide of capital availability, commercial/multifamily real estate has been riding an even higher wave. In recent years, real estate increasingly has been "discovered" as an investment staple.

The anecdotes are compelling. In 2003, the regents of the University of California, who manage the university's pension portfolio, decided to increase their allocation of investments designated for real estate from 0 percent to 5 percent (to $2.2 billion, based on their current portfolio size). After three years, they had succeeded in placing just $0.2 billion, leaving another $2 billion still looking for opportunities.

In another example of the now-central role of real estate, a sample query of the retirement planning tool on New York–based Teachers Insurance and Annuity Association, College Retirement Equities Fund's (TIAA-CREF's) Web site suggests—for certain moderately conservative individuals—a real estate allocation of 10 percent.

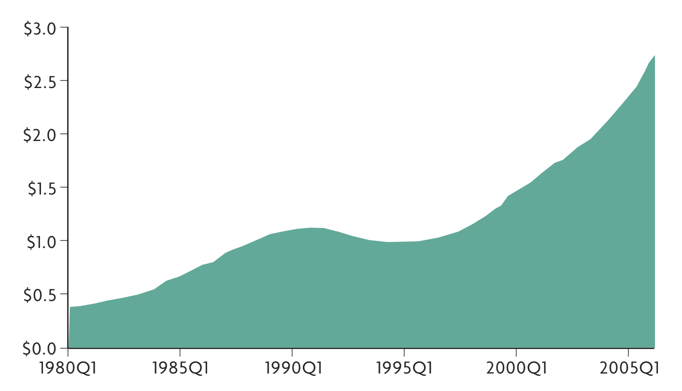
And retirement planning is not alone in driving dollars to real estate. Investment funds have become some of the largest sources of the extra capital boost real estate has been experiencing, with real estate investment trust (REIT) privatization

Figure **1** **Corporate Bond Credit Spread (AAA–BBB)**



Source: Standard & Poor's Global Fixed Income Research

Figure **2** **Commercial/Multifamily Mortgage Debt Outstanding ($ trillions)**



Source: Federal Reserve Board

sweeping up such huge names as Equity Office Properties Trust and CarrAmerica Realty Corporation.

The same is, of course, true for commercial/multifamily mortgage debt. After setting records in almost every category in 2005, the commercial/multifamily real estate finance market was still going strong in 2006. The $345 billion of commercial/multifamily lending volume in 2005 was up an incredible 50 percent from 2004, and through the first three quarters of 2006 origination volumes surpassed levels from the same period in 2005.

According to most market experts, for most property types the United States is currently on its way out of the most recent trough.

At the end of 2005, commercial/multifamily mortgage debt outstanding stood at $2.6 trillion—14 percent higher than it had been at the beginning of the year (see Figure 2). By the second quarter of 2006, that level had risen another 5.6 percent, or almost $150 billion. CMBS conduits, life companies, commercial banks, Fannie Mae, Freddie Mac and other investors all continue to invest more and more heavily in commercial/multifamily mortgages.

The result—for both equity and debt—has been an extra boost in prices and a drop in yields. Data from New York–based Real Capital Analytics Inc. show sales volume of significant properties hit $213 billion in 2005, up from $55 billion in 2001—while over the same period, cap rates dropped from 9.6 percent to 6.7 percent.

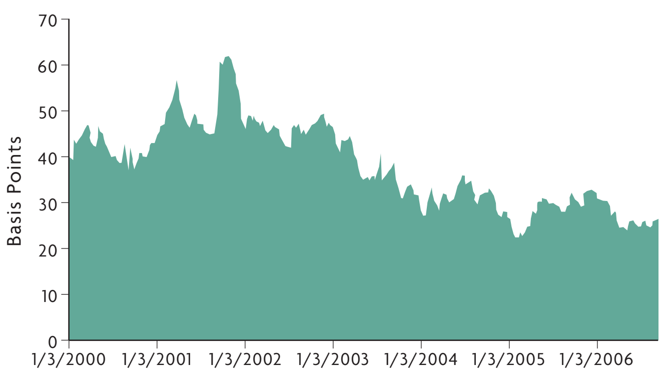
The same is true for the fixed-income instruments backed by commercial/multifamily real estate. Spreads on life insurance company loans, as measured by the American Council of Life Insurers (ACLI), Washington, D.C., fell from 251 basis points in 2001 to 130 basis points in 2005 as commitment volume swelled from $27 billion to $43 billion. And spreads of AAA-rated CMBS to swaps dropped from 43 basis points at the end of 2000 to 32 basis points at the end of the 2005 (see Figure 3), as CMBS outstanding rose from $232 billion to $522 billion.

And so this first front that has parked over the commercial/multifamily finance markets is really a combined front—or a front upon a front. A rising tide of capital has increased capital availability for all credit products. Yet, on top of that, a swell in interest in commercial/multifamily real estate investment options has buoyed investment in our market to even higher levels.

A point that needs to be made is that the "discovery" of commercial/multifamily real estate and the resulting flow of capital into the sector is not likely to be undone. What was until recently a harbor for a smaller number of specialized investors has become an open market.

For real estate investors, this means that the high relative returns that were once commonplace are unlikely to be seen again. It also means that the component of recent returns fueled by this discovery is not likely to be repeated, nor is its long-term impact on values likely to be lost.

Figure **3** **10-Year Fixed Conduit Spreads to Swaps**



SOURCE: MORGAN STANLEY

Front 2: Property performance

REAL ESTATE CYCLE

The second front affecting the commercial/multifamily markets—the real estate cycle—is as regular and dependable as the jet stream. Some economists have tracked real estate cycles back to 1818, and despite our best efforts, the cycle remains a fact of life today.

In its most basic form, the real estate cycle is the ebb and flow of real estate construction (supply) and the absorption of space (demand).

At the trough of the cycle, demand begins to outpace supply, pushing prices (rents) up and vacancies down. The natural market reaction to this is to develop more supply, and construction ensues.

As construction comes on line—usually more than fully anticipated—and supply begins to outpace demand, we reach the top of the cycle. At that point, we begin to see rents flatten and then decline, and vacancies flatten and then rise. In reaction, construction slows, allowing demand to eat into the overhang of space. As we re-enter the cycle's trough, rents again begin to trend up and vacancies down, and the cycle begins anew.

It is important to note that across the U.S. economy—from the gross domestic product (GDP) to residential investment to other areas—volatility has been greatly reduced. This stability has meant fewer and less pronounced downturns, and a more stable environment in which businesses plan and operate with more certainty. Not only has the real estate sector benefited from this diminished volatility, it likely has been a stabilizing force and a cause of diminished cyclicality in the economy at large.

According to most market experts, for most property types the United States is currently on its way out of the most recent trough. Individual markets vary, but rents are generally rising, vacancies are generally falling and more construction cranes are evident in more markets.

The result—for the time being—is a period in the real estate cycle when property operations are improving and owners (and lenders) are benefiting from rising incomes. With new supply still at moderate levels, the outlook for most local property markets is positive.

Property perspectives

Evidence of this comes in the research reports of analysts tracking the property markets. Each quarter, New York–based Moody's Investors Services puts together its *CMBS: Red-Yellow-Green™ Update* report on the state of major U.S. property markets. The methodology looks at property-specific, metro-area markets and assesses each based on current conditions vis-à-vis the anticipated balance between growth in supply and demand.

By assessing individual markets, their current conditions and anticipated growth, Moody's is able to give each market a score from zero to 100 and a color code, with green markets having a score of 67 to 100, yellow markets having a score of 34 to 66 and red markets having a score of 33 or lower. The higher (and greener) the score, the stronger the property market.

In the first quarter of 2006, according to Moody's, every property type had a composite cross-metro area score of either green or high yellow (see Figure 4). In fact, across 357 property-specific, metro-area markets, only 22 were rated as red. An additional 138 were rated as yellow, and 197 were rated as green.

Impact on incomes

The improving rents and vacancies translate directly into improving bottom lines. Looking at "same-store" net operating incomes (NOIs) from REITs shows the impact of these improving property markets on the bottom line.

Indexing each property type's net operating income to 100 in 1999, one sees drops in multifamily and office NOIs starting in 2002 and running through 2004. The office decline was due to a slowing economy and large numbers of leases rolling from higher rents to lower. The multifamily decline was caused by the flow of households from renting to homeownership.

Since 2004, across all property types, the reported NOIs have been moving steadily upward, evidence of the improvements occurring in the market as a whole (see Figure 5).

For the commercial/multifamily finance markets, these improving property fundamentals mean more properties are able to more easily meet their financing obligations, which means, as we'll see, greater stability and greater calm throughout the commercial/multifamily finance markets.

While these first two "fronts"—widely available credit and steadily improving property markets—are sufficient on their own to calm the waters of commercial/multifamily finance, adding the third—innovations in real estate finance—has moved the market into uncharted territory. This has created what I am calling the "perfect calm."

Front 3: Innovation in real estate finance

Commercial/multifamily finance is one of the most innovative capital markets in the world. In 2005, Federal Reserve figures show, the debt markets funneled an additional $326 billion of capital into real estate properties, surpassing $2.7 trillion in mortgage debt outstanding. This market can easily digest loans of hundreds of millions of dollars and of hundreds of thousands of dollars. But the greatest strength of the market is its innovation.

The traditional—and still most common—method by which investors provide capital to commercial/multifamily mortgages is through whole loans. With whole loans, an investor takes on the entire set of risks and rewards associated with each loan in its portfolio.

At the end of the second quarter of 2006, the Federal Reserve reported 77 percent of commercial/multifamily mortgage debt outstanding ($2.1 trillion) was held as whole loans. Commercial banks, life insurance companies, savings institutions, GSEs and others all hold significant volumes of whole loans on their books. With these loans, the investors enjoy the undiluted income from the loans in return for holding the undivided risks that come with them.

There are many advantages to whole-loan investment, but the number of investors with the appetite to take on the analysis and management responsibilities of whole-loan investing is limited.

Enter commercial mortgage-backed securities. From their birth in the 1990s to their maturation in the 2000s, the innovations of the CMBS market have made investing in commercial/multifamily mortgage debt accessible to a new class of investors.

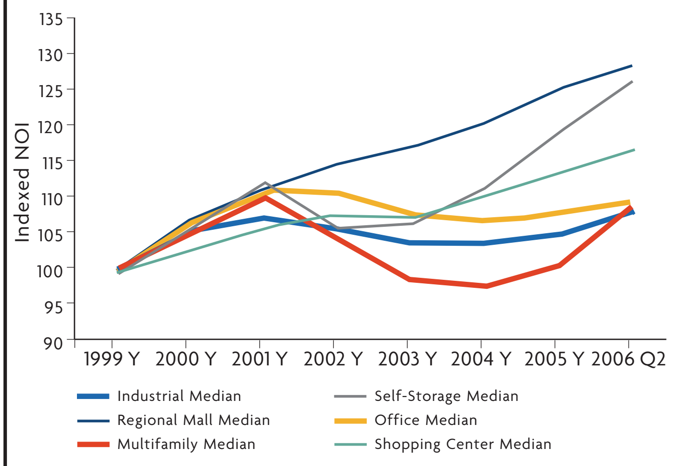
CMBSs work by grouping mortgages in a pool and tranching

Figure **4** **Moody's *Red-Yellow-Green*™ Report Composite Scores**

	Color	Score
Multifamily	Green	81
Retail	Green	84
Office (CBD)	Green	71
Office (Suburban)	Yellow	59
Industrial	Green	68
Hotel (Full-Service)	Yellow	66
Hotel (Limited-Service)	Green	80

Source: Moody's *Red-Yellow-Green*™ Report, July 2006

Figure **5** **Indexed REIT/REOC Same-Store Net Operating Income (NOI), by Property Focus (1999 = 100)**



Sources: MBA and SNL Financial

(or dividing) the risks among a series of securities. By structuring the priority by which the different securities are repaid, CMBSs create some security classes (AAAs, AA, A) that are safer and others (BBB to unrated) that have more risk associated with them. The yields paid by the different classes are commensurate with each class' perceived risk.

The result of this innovation has been a set of investment vehicles that have become the leading source of capital for significant commercial/multifamily properties. But the innovation doesn't end there. As the CMBS market has identified new investor groups, it has also created new investment vehicles to cater to those groups' risk/reward or other tolerances.

Another key element of the innovation of the CMBS market has to do with information and its use.

"Super-senior" tranches were created when investment banks identified a demand for securities with even greater protection than the standard AAA. Interest-only and short-term tranches have been created to meet the demands of investors with other sets of liability-matching needs. The market continues to create new ways of matching investor dollars to real estate finance needs.

Another key element of the innovation of the CMBS market has to do with information and its use. Never before has so much information been available about commercial/multifamily finance. Loan-level information on more than $560 billion of CMBS is readily available. Increasingly sophisticated models based on those data are predicting probability of defaults and loss given defaults on individual loans as well as complex portfolios. Because of these innovations, the facility to understand and analyze commercial/multifamily investments has never been greater.

The collateralized debt obligation (CDO) market is the latest manifestation of the market's innovation. CDOs are similar to CMBSs in many ways, but differ in terms of the assets they can hold, the level of asset management allowed and many other characteristics. Important to note, however, is that the CDO market has filled many of the financing holes the CMBS market could not.

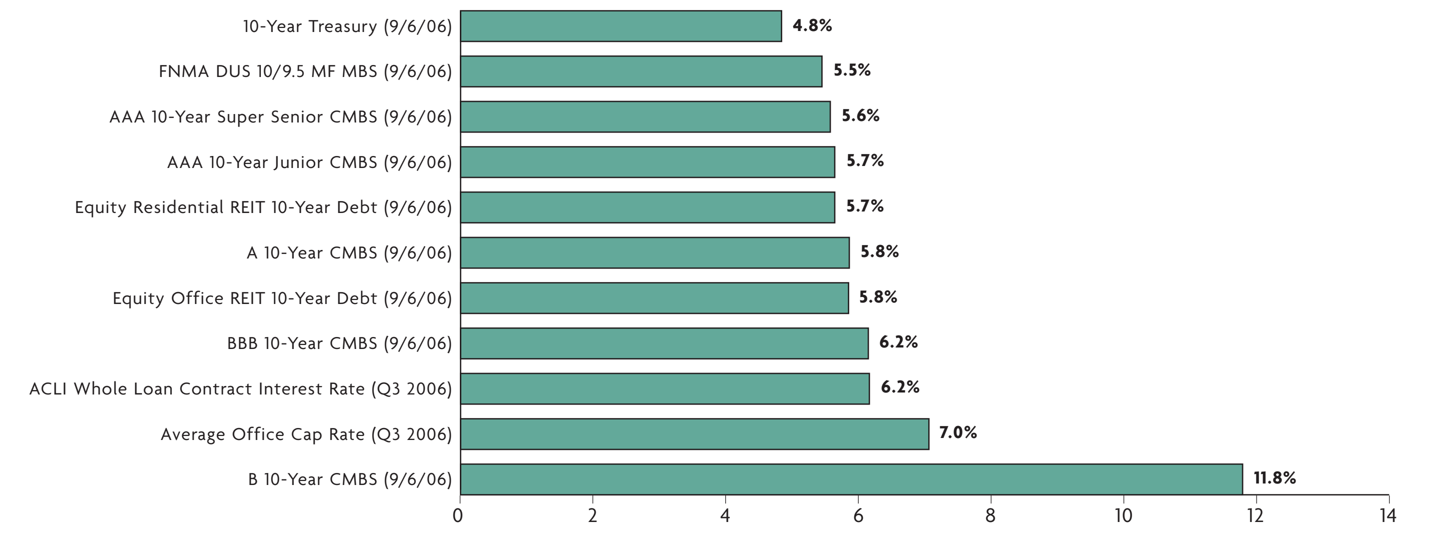
CDOs, for example, offer a financing option for a range of real estate assets such as transitional properties and land deals that do not fit into the CMBS box. CDOs also offer an additional investor group and capital source for CMBSs. Many CDOs include as assets lower-rated CMBS securities, thus providing greater liquidity to this important portion of the capital stack, thereby bringing down CMBS borrowing costs.

Mezzanine, participations, negotiated terms

But the public markets aren't the only place where innovation is helping investors match their risk/reward tolerances through real estate. Investors, particularly whole-loan investors, have been using a host of financing techniques to more finely carve out the risks and rewards that match their comfort levels—thereby bringing lower rates to their borrowers. Through mezzanine debt (which holds a second or third priority or no claim at all to the underlying property), loan participations and B-notes (in which multiple lenders each participate in a single loan), highly negotiated terms and other techniques, lenders are able to slice-and-dice the risk associated with real estate lending and direct different levels of risk/reward to different investors.

According to the Mortgage Bankers Association's (MBA's) 2005 annual survey of commercial/multifamily origination volumes, between 2004 and 2005, commercial/multifamily lending in general rose by 50 percent, but mezzanine lending increased by nearly 300 percent.

Figure **6** **Yields on Selected Real Estate–Related Investments (%)**



SOURCES: MORGAN STANLEY, REAL CAPITAL ANALYTICS, ACLI

Menu of investment options in CRE

The result of these various innovations has been that investors now have a long menu of investment options from which to choose. These range from multifamily-backed securities issued and guaranteed by the GSEs to various tranches of CMBS to REIT-issued debt to whole loans and property equity.

Figure 6 lists a sampling of these investments and their relative yields. These options have allowed investors to more specifically tailor their investments to their own risk/reward profiles, in turn making commercial/multifamily real estate a more attractive investment option for a much wider audience. The result has been record flows of capital into real estate equity and debt—flows that have boosted property values, lowered borrowing costs and provided the third, and perhaps most lasting, calming effect on the markets.

In the second quarter of 2006, commercial/multifamily mortgage loans were performing better than any other types of loans made by commercial banks.

Result: Performance

How calm are the commercial/multifamily real estate waters? Whether looking at mortgage delinquency rates, ratios of rating agency upgrades-to-downgrades or any one of a number of other measures, it becomes clear the commercial/multifamily real estate finance markets are very, very calm.

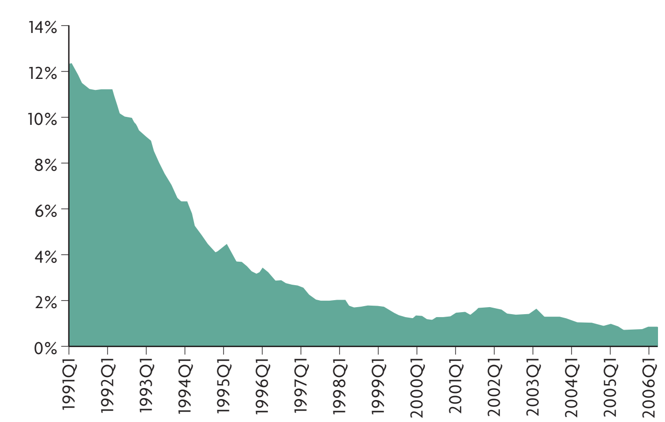
Delinquency rates

In the second quarter of 2006, commercial/multifamily mortgage loans were performing better than any other types of loans made by commercial banks. The 30-plus-day delinquency rate for commercial/multifamily loans was 1.01 percent—the lowest it has been since the Federal Reserve series began in 1991 (see Figure 7). This compares with 30-plus-day delinquency rates of 1.59 percent reported by the Federal Reserve for single-family loans, 1.27 percent for commercial and industrial loans, and 1.5 percent for all loans and leases.

What's even more telling is that not only are the delinquency rates on commercial/multifamily loans lower than those for these other loan types, but most of these other loan types are also experiencing record-low delinquency rates. This makes current commercial/multifamily mortgage performance the best of the best.

And commercial/multifamily delinquency rates are not only low and calm at commercial banks. Sixty-plus-day delinquency rates at other investor groups are also at or near historic lows. Life company delinquency rates in the third quarter of 2006, as reported by ACLI, were at 0.04 percent for the third quarter in a row. CMBS delinquency rates, as reported by Charlotte, North Carolina–based Bank of America, were 0.22 percent; Fannie Mae's multifamily delinquency rate was 0.11 percent and Freddie Mac's reported multifamily delinquency rate was 0.00 percent.

Figure **7** **Commercial/Multifamily 30-Plus-Day Delinquency Rates at Commercial Banks**



Source: Federal Reserve Board

Upgrades/downgrades

The strong performance of the loans also has affected bonds backed by commercial/multifamily loans. Through September 2006, rating agencies took 3,102 ratings actions—either upgrading or downgrading the ratings of individual CMBS securities. Bank of America recorded that almost 2,900 of those actions were upgrades, meaning the agencies upgraded securities 14 times more often than they downgraded them.

The ratings upgrades are based on a number of factors, from improving property performance to increased security strength resulting from defeasance activity. The bottom line, however, is that commercial/multifamily investors have not only seen strong performance from the assets backing their bonds, but they have also seen their investments upgraded—making those securities more valuable in an absolute sense.

And so, whether talking about loans, bonds or properties, the performance of the commercial/multifamily market is in a period of tremendous—even perfect—calm.

Clouds over the horizon?

As with any period of calm, the discussion quickly turns to what fronts are moving in to put an end to the overall placid conditions, and this period is no different. Participants throughout the industry are (rightly) scanning the horizon for signs of inclement weather that may be heading our way. And while no thunderheads are imminent, it's worth raising a couple of the likely suspects that could start moving in.

New construction

Construction is the traditional source of waves in the commercial/multifamily market, and it has been the source of the biggest storms—most recently the real estate crash of the late 1980s. There is much better information available on construction activity today, which should help moderate the ups and downs the market is used to.

At present (as is appropriate in the current stage of the real estate cycle), construction is starting to pick up in certain markets. With changes in construction costs, innovations in the financing of construction and questions about the economic growth that drives demand, it will be as important as ever for the market to keep an eye on construction activity and its potential impact on the performance of both new and existing properties.

Balloon risk

The commercial/multifamily market has traditionally been a market of 10-year, prepayment-restricted balloon mortgages. While this has led to greater stability through interest-rate fluctuations, it will also be a key driver of balloon risk in coming years. Starting in earnest in 2008, the market will see significant volumes of loans coming due, each requiring some form of refinancing.

To the degree that property incomes, property values, mortgage rates or other key drivers of the financing equation are significantly different than they are today, the refinancing of these balloon mortgages could become difficult, leading to increases in term defaults. The innovations of the capital markets mean that there are more sources than ever for both the equity and debt needed to refinance. The real questions become what gaps in that financing could exist, and who will be called upon to fill them.

Financial-market shock

As the commercial/multifamily markets have become more tied to international capital markets, they have also become more sensitive to the ebbs and flows in those markets. To the degree that there are capital-market shocks—most likely not directly related to commercial/multifamily real estate—the commercial/multifamily markets will be affected.

This was the case in 1998 when Greenwich, Connecticut–based Long-Term Capital Management's problems spilled into other markets and pushed credit spreads wider for nearly every asset class. The good news here is that, based on the Long-Term Capital Management experience, the markets work through the repricing and other necessary activities in relatively short order. The bad news is that even with the most careful risk management by the industry, there is little it can do to prevent such an exogenous event.

Summing up

The commercial/multifamily real estate finance industry is enjoying an unprecedented period of calm. The key forces at play—availability of capital, property performance and innovations in real estate finance—are all exerting positive, calming influences on the market.

Participants throughout the industry are well aware of the importance of keeping a weather-eye for threats to this stability. Through the work of underwriters, servicers, investment banks, rating agencies, regulators and others, they are doing just that.

While it's impossible to predict with certainty how long this perfect calm will last, many of the changes that came with it—from innovative capital structures to a deeper, broader investor base—are likely to be with the industry for good. MB

James R. Woodwell is senior director of commercial/multifamily research for the Mortgage Bankers Association (MBA) in Washington, D.C. He can be reached at jwoodwell@mortgagebankers.org.