A Detour to Dis-Equilibrium

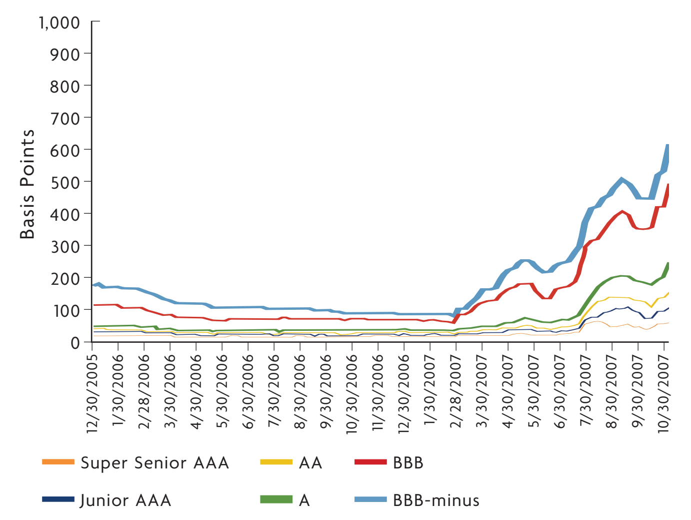
BY JAMIE WOODWELL

Last year, the commercial real estate capital markets moved from a "perfect calm" to a state of dis-equilibrium—in the course of a few months. This article tracks the capital markets' course from equilibrium to dis-equilibrium and, ultimately, to some future state where buyers and sellers will once again transact routinely.

Economists use the word "equilibrium" to describe a market steady enough that buyers and sellers can come to a shared understanding of the prices and terms at which transactions will occur. To economists, markets function at equilibrium. When a shock hits a market—a dramatic shift in supply or demand—the market moves to dis-equilibrium. When that happens, buyers and sellers cannot come to terms, the market slows and little new business is transacted. Participants then adjust terms and pricing in search of a new level at which transactions can again occur. When that new level is found, trading begins again at its new equilibrium.

Like many aspects of the dismal science, equilibrium tends to be a largely theoretical concept, with most economists observing that few markets are ever in a true state of equilibrium. But the recent disruptions in the commercial/multifamily real estate finance markets show that dis-equilibrium can be very real, and it can have dramatic consequences as the market searches for its new level.

Figure **1** **CMBS Spreads to Swaps**



SOURCES: MBA AND COMMERCIAL REAL ESTATE DIRECT

Figure **2** **CMBS Spreads to Swaps (2007)**

	2/23/07	11/23/07	Change, bps	% Change
Super Senior AAA	23	109	86	374%
Junior AAA	29	195	166	572%
AA	33	235	202	612%
A	41	368	327	798%
BBB	68	738	670	985%
BBB-minus	85	850	765	900%
BBB-minus less Super Senior AAA	62	741	N/A	N/A

SOURCE: COMMERCIAL REAL ESTATE DIRECT

Equilibrium and the perfect calm

In the beginning of 2007, I categorized the state of the commercial/multifamily real estate finance market as a perfect calm (see "The Perfect Calm," *Mortgage Banking,* January 2007). Low interest rates and broad capital availability, strong and improving property markets, and innovation in the capital and other markets all came together to create extremely benign market conditions. Mortgage originations, mortgage debt outstanding and property prices all hit record highs, while cap rates and delinquency rates each hit record lows.

A key (and then un-noted) element of this market was that it was in equilibrium. Buyers and sellers shared an understanding of market fundamentals such that they could transact business. Not everyone agreed that the terms were "right," but the market transacted at those terms and deals took place.

Investors around the globe had increased their demands for high-yielding fixed-income investments, and as in any functioning market, firms and individuals responded by supplying products to meet the increased demand. The result was that leading up to the summer of 2007, the global capital markets provided commercial/multifamily real estate with an extremely efficient delivery of investment funds.

According to Commercial Real Estate Direct, more than $200 billion of commercial mortgage-backed securities (CMBS) were issued in 2006. Wachovia Capital Markets LLC, Charlotte, North Carolina, and Intex Solutions Inc., Needham, Massachusetts, reported that at the end of second-quarter 2007, there was almost $725 billion in CMBS outstanding.

To capture this investor demand, investment banks created new structures—such as the commercial real estate collateralized debt obligation (CRE CDO)—that more finely tailored risks and rewards, and provided opportunities for investors to choose from a variety of investment options. The demand drove a record $36.6 billion of issuance of CRE CDOs in 2006.

The growth of the CRE CDO market—with its appeal to hedge funds and other leveraged investors—helped increase demand for CDO inputs, especially lower-rated CMBS tranches, which in turn helped drive the prices of CMBS up and their yields down. At the end of February 2007, CMBS were priced at record low levels to swap rates, and the differences in yields paid by riskier securities (such as those rated BBB-minus) and less-risky securities (such as those rated AAA) were at their smallest in years (see Figure 1).

At that time, an investor in the BBB-minus security might receive a yield only 62 basis points higher than an investor in a super senior AAA, nearly risk-free security (see Figure 2).

Dis-equilibrium

Then came dis-equilibrium in the global credit markets.

Starting in the spring of 2007, first with the drop in the Chinese stock market and then with concerns about the single-family housing market, demand in some parts of the CMBS market shrank dramatically. Many of the investors that had been driving the market—including foreign investors, hedge funds, collateralized debt obligation managers and other institutional investors—pulled back. Others began to re-evaluate their assumptions and risk-reward trade-offs and thus the yields they would demand to invest in CMBS.

The result—following the classic rules of Economics 101 that describe the consequences of a drop in demand—was a drop in prices, which translates to an increase in yields.

But the most significant impact on the market did not come from a repricing of risk. The most significant impact came from dis-equilibrium in the market, when buyers and sellers could not find a common level at which they could transact business. The difference between "bid" and "ask" pricing was significant. Potential buyers of CMBS had one expectation of the value (and hence price) of the securities, while potential sellers had a (significantly) different expectation.

By November, spreads on CMBS had risen to their highest levels on record, as had the difference between lower-rated tranches and higher-rated tranches. On Nov. 23, 2007, Commercial Real Estate Direct reported super senior AAA spreads at 109 basis points over swaps and BBB-minus spreads at 850 basis points over swaps—meaning a difference of more than 740 basis points between the super senior AAA and the BBB-minus credit classes.

The dis-equilibrium in the CMBS market slowed it to a crawl.

According to *Commercial Mortgage Alert,* in the first eight months of 2007, a total of $188 billion of CMBS was issued—an average of $23.6 billion per month (see Figure 3). In the following three months, $26.3 billion was issued—an average of $8.8 billion per month.

Many are now predicting that 2008 CMBS issuance volume will be half—or less—of what it was in 2007.

At the time of this writing, the CMBS market is still seeking its new equilibrium. Where that new level stands will be determined by where buyers and sellers of CMBS come together around the terms (stressed loan-to-value ratios [LTVs], rent and vacancy assumptions, acceptance of interest-only loans, subordination levels) and prices of the loans and bonds that make up the market.

The timing for reaching that new level will be determined by when market participants develop a degree of commonality in their views about what factors are driving the markets and a shared view about their terms and prices.

Originations markets

The dis-equilibrium in the capital markets has flowed into other aspects of commercial/multifamily real estate, but the farther one gets from the capital markets, the more muted the impact has been.

The commercial/multifamily originations market is heavily influenced by the CMBS and other secondary capital markets, but it is also one step removed.

In 2006, the Mortgage Bankers Association's (MBA's) annual commercial/multifamily mortgage origination survey recorded more than $406 billion in originations, with CMBS markets providing 46 percent of the volume. As a result, the freeze-up of the capital markets had a near-immediate impact on the overall commercial/multifamily mortgage origination market. But with 54 percent of 2006 originations coming from sources other than CMBS, the originations market also retained more stability than did the market for CMBS (see Figure 4).

Equilibrium

Firms purchasing—and originating—loans for inclusion in CMBS need to have a relatively firm understanding of where the CMBS market will be when the securities that hold their loans are priced. To make the economics work, when yields on CMBS rise (or fall), the yields charged to CMBS borrowers also need to rise (or fall) accordingly. Similarly, if investors demand tighter (or looser) underwriting, or higher (or lower) subordination levels, that needs to flow back to the loan origination and pooling process.

Leading up to the summer of 2007, originators, issuers, investors and others had a good shared understanding of the going terms and rates for loans to be included in CMBS. The strength of global demand for CMBS meant that these terms and prices tended to be looser than those of other investors, such as life companies, the government-sponsored enterprises (GSEs), banks, thrifts and others. Not all observers agreed that the going terms and rates were right, but buyers and sellers cleared them, and the market was at equilibrium.

Dis-equilibrium or 'dat-equilibrium?

As the CMBS market entered a state of dis-equilibrium, however, that shared understanding in the CMBS origination market weakened, and originators faced increased risks that loans they originated for CMBS would not match the capital market in which those loans would ultimately be priced.

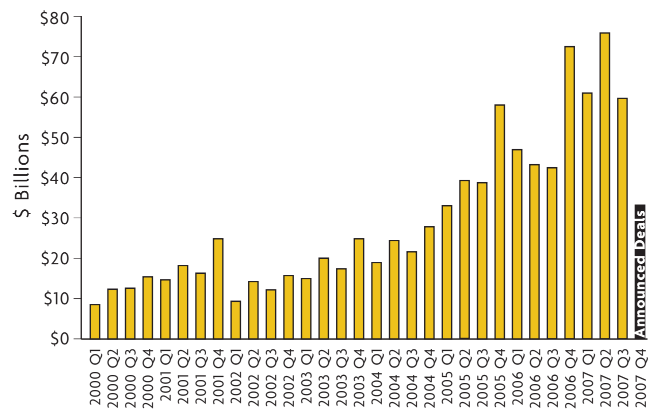
While commercial/multifamily CMBS conduits tried to rapidly realign their loan programs to match the new (and changing) market conditions on Wall Street, the dis-equilibrium made that task Herculean. Loan pricing was raised, underwriting was tightened and volumes were reduced, but there was little certainty about where the market would be when loans were ready to be securitized. The dis-equilibrium in the capital markets slowed originations for CMBS.

But CMBS conduits are not the only source of capital for commercial/multifamily real estate. Life companies, the GSEs—Fannie Mae and Freddie Mac—and others continue to provide a significant amount of debt capital to the real estate markets. And with the CMBS market sidelined, these lenders saw a pick-up in demand for their loans.

According to the American Council of Life Insurers (ACLI), Washington, D.C., loan commitments by life companies in the third quarter of 2007 increased to $11.5 billion, up 12 percent from the second quarter and up 1 percent from the same quarter the previous year.

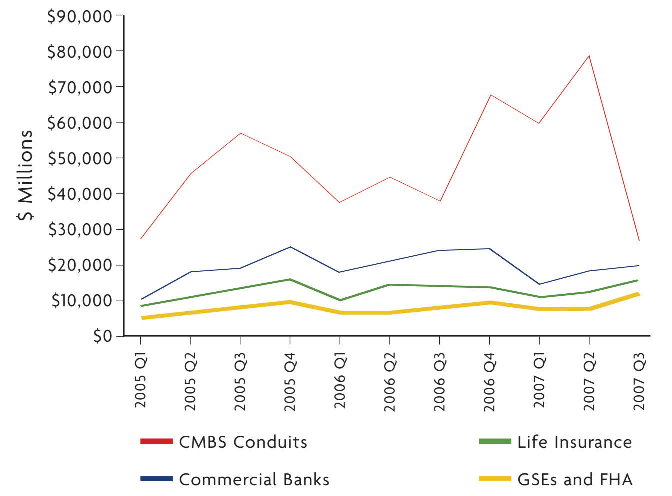
Fannie Mae and Freddie Mac were each on their way to record years for multifamily production even before the midsummer deepening of the credit crunch. A July press release

Figure **3** **CMBS Issuance**



SOURCE: CMALERT.COM

Figure **4** **Quarterly Commercial/Multifamily Mortgage Originations by Investor Group**



SOURCE: MBA

from Fannie Mae was titled, "Fannie Mae Invests $27.2 Billion in Multifamily Housing during the First Half of 2007, Sets Record for 6-Month Production."

According to MBA's quarterly survey of commercial/multifamily mortgage banker originations, CMBS conduits saw a 28 percent decline in origination volume between the third quarter of 2006 and the third quarter of 2007, but the market as a whole only slowed 4 percent—largely due to pick-ups in originations by life companies and the GSEs.

Given the size of the CMBS market, some have questioned how the rest of the market—including life companies, GSEs, commercial banks, thrifts and others—could make up for the slowdown in CMBS originations. The short answer is they probably will not need to.

The demand for mortgage originations (both acquisitions and refinances) in recent years was fueled by the same capital availability that fueled the growth of the CMBS market. The recent credit crunch has slowed this demand for commercial/multifamily mortgage debt at the same time it is slowing the supply of it.

The result has been that while the origination market has shifted, in pricing and terms, it has not become unmoored. Most lenders and borrowers can still come to terms on a loan. The terms will likely not be as generous as they would have been a few months ago, but the mortgage origination market has thus far avoided a full-blown state of dis-equilibrium, and instead appears to be moving from one equilibrium state to another, new equilibrium state: 'dat-equilibrium.

Property sales markets

Like the mortgage origination market, the commercial/multifamily property sales market has also been affected by the capital market's dis-equilibrium. Partly, the sales market is experiencing a downshift as volumes come down from the dizzying heights experienced during the recent leveraged buy-out (LBO) wave. Partly, it is feeling a domino effect in which debt terms in general have become more restrictive and more expensive, and the economics of property acquisitions have shifted.

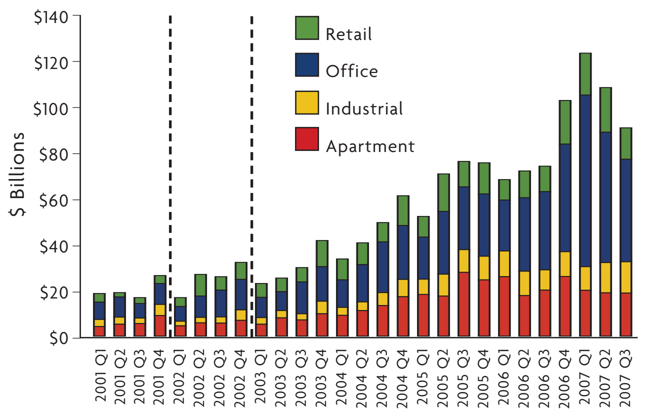
According to a November 2007 article in *Real Estate Portfolio,* during 2006 there were 23 mergers and acquisitions (M&As) of real estate investment trusts (REITs), with a total value of $106 billion. Through September of last year, another 17 deals with a total value of $71 billion had been recorded in 2007.

Included among these transactions were the privatizations of Equity Office Properties Trust, Chicago (at $39 billion); Archstone-Smith Trust, Englewood, Colorado (at $22 billion); CNL Hotels & Resorts Inc., Orlando, Florida (at $7 billion) and many more.

As the purchasers of these and other portfolios right-sized their holdings by selling off properties that did not fit with their investment criteria or portfolios, a significant number of underlying properties were resold (and refinanced)—some multiple times. Each sale brought with it increased sales volumes along with new prices and new cap rates.

These dizzying heights were not limited to the large portfolios. Many individual investors similarly saw opportunities in acquiring individual properties, often enhanced by the availability of leverage.

Figure **5** **Commercial/Multifamily Property Sales Volume Properties and Portfolios, $5 Million and Greater**



SOURCE: REAL CAPITAL ANALYTICS

The result was more new records. In 2006, according to Real Capital Analytics, New York, $319 billion of properties and portfolios of $5 million or more changed hands—a 16 percent increase over the year before (which had seen a 48 percent increase over 2004) (see Figure 5). Through just the first half of 2007 (the first half tends to be slower than the second half), $229 billion in properties had changed hands—a 62 percent increase over the same period the year before. Prices and cap rates had followed suit, with prices in the second quarter of 2007 29 percent higher than during the second quarter of 2006, and cap rates 50 basis points lower.

It needs to be recognized that the statistics themselves are affected by the heavy M&A activity that was taking place and the types of properties changing hands in those transactions. Many of the REIT and portfolio properties changing hands during this period were of exceptional quality. As a result, the bias toward higher-quality assets in the transaction data during this period tends to push the average prices up and average cap rates down, regardless of what was happening to those measures in the market at large.

Many have commented that the record volumes, prices and cap rates seemed extraordinary—and by previous and current conventions, they were. But at the time, they were a product of a market functioning at equilibrium. Buyers (often many of them) came to those terms with sellers to make the transactions close.

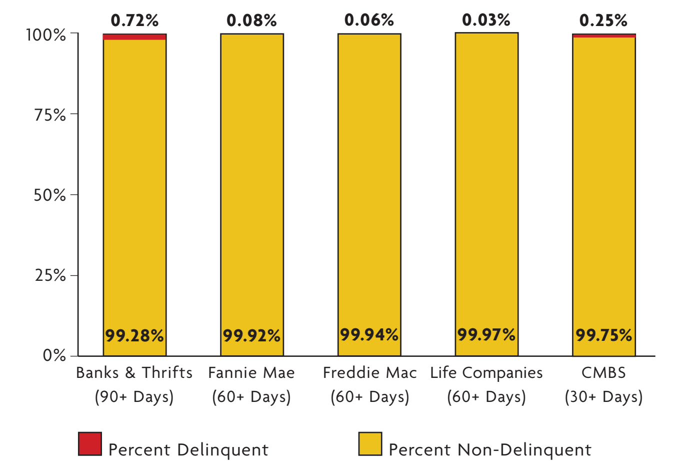
'Dat-equilibrium

Given the leverage typically used to finance the purchase of commercial/multifamily properties, there should be little surprise that changes in the supply of capital have begun to have an effect on the volume and terms of property sales.

According to Real Capital Analytics, sales volume of commercial/multifamily properties and portfolios of $5 million or more fell by 25 percent in September, and cap rates generally ticked up. The drop in October was even more severe.

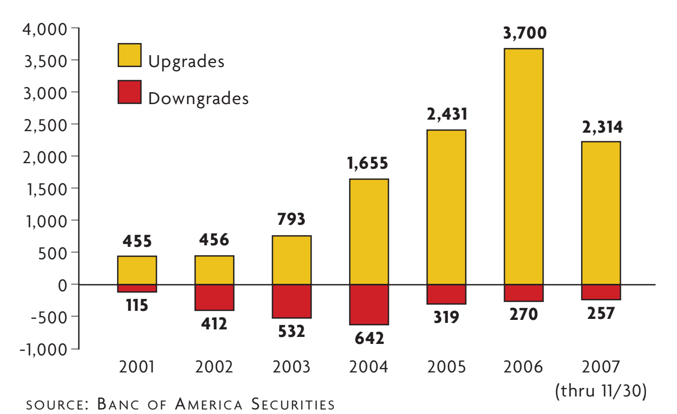
In its October release, Real Capital Analytics noted, "Cap rates for suburban office and strip centers appear to be the most affected, and are up by as much as 50 basis points while

Figure 6 **Multifamily Delinquency Rates by Investor Group (9/30/07)**



SOURCES: FANNIE MAE, FREDDIE MAC, FDIC AND BANK OF AMERICA

Figure 7 **Summary of CMBS Upgrades/Downgrades by Year of Action**



SOURCE: BANC OF AMERICA SECURITIES

most other property types have seen an increase closer to 25 basis points. The exception is CBD [central business district] office towers, where cap rates have dropped even lower. Value-added deals are being repriced more than core, as are secondary and tertiary locations compared to primary markets."

A key challenge in this period is separating the impacts driven by the capital market disruptions from the ebbs and flows that are a natural part of the real estate cycle. The record low cap rates of recent years, for example, had priced into them strong anticipated gains in property incomes. As those gains are realized, it is natural for the cap rates to face upward pressure. Given current conditions, however, it will be difficult to determine how much of the contemporary rise in cap rates is natural and how much is caused by dis-equilibrium in other parts of the market.

It is also important to note that there remains a great deal of equity capital aimed at commercial/multifamily properties. And given the recent price increases in property values, the vast majority of property owners hold considerable equity in their properties.

In the face of the falling October sales volume, Real Capital Analytics noted, "The question . . . is if this inflection signals the end of this five-year bull market for commercial real estate. That is not so clear. This cycle has been generated by strong capital inflows and the emergence of property as a true asset class. Capital continues to flow into commercial property, especially on a global basis, and the greater cycle may not be over."

Property fundamentals

Unlike the mortgage origination and property sales markets, the markets that support the operations of commercial/multifamily properties are largely divorced from the capital markets, with all their disruptions over the past four months. And the prospects for these property markets remain generally strong.

According to a Nov. 6, 2007, report from Wachovia Capital Markets, "about 94 percent of the 200 CRE markets we forecast are stable (101) or revenue growth markets (86), which should temper the inevitable rise in CMBS defaults from current historical lows."

Across all major property types, Wachovia forecasts effective revenue growth of 4.4 percent in 2007 and 3.2 percent in 2008. And while many market analysts are forecasting slowing income growth in the coming year, the forecast is still for growth.

Those forecasts may say more about the strength of recent income growth than about any future weakness in income growth. Moody's Investor Services, New York, affirms this view in its *Red-Yellow-Green®* report for the third quarter of 2007. Moody's noted, "For the third consecutive quarter, five of the seven property types are green [with positive conditions and outlook] and fewer than 9 percent of individual markets have red [negative conditions and outlook] scores."

One area of concern regarding property fundamentals is that the growth these properties experience doesn't match investors' bullish predictions. To the degree underwriters—either on the debt or equity sides of the deal—based their analyses on forecasts significantly more aggressive than what plays out, the performance of those investments will not match expectations. While we are likely to see cases of this in coming quarters, the fact remains that most properties continue to perform well and that, on a national basis, growth continues to be the forecast.

Loan and bond performance

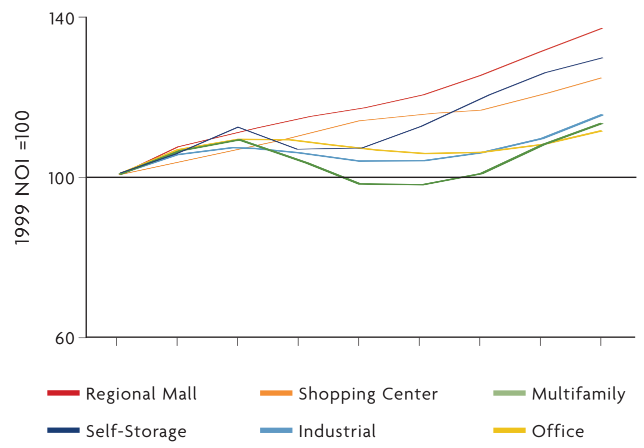
Thanks in large part to the strong property markets, commercial/multifamily loans and bonds continue to perform well—in fact, at this point in time, extremely well.

Across investor groups, delinquency rates remain at or near historically low levels. At the end of the third quarter of 2007, Charlotte, North Carolina–based Bank of America reported the 30-plus-day delinquency rate for CMBS loans was 0.33 percent (up just slightly from its record low of 0.30 percent the month before). The Federal Deposit Insurance Corporation (FDIC) reported a 90-plus-day delinquency rate on loans in bank and thrift portfolios of 0.72 percent. Fannie Mae reported a 60-plus-day delinquency rate of 0.08 percent on its multifamily loans, and Freddie Mac reported a 60-plus-day delinquency rate of 0.06 percent (see Figure 6).

Loans are performing at unprecedented levels.

This strong loan performance has spilled over to bonds

Figure 8 **Indexed Median REIT/REOC "Same Store" Net Operating Income (NOI) by Property Focus**



SOURCES: MBA AND SNL FINANCIAL

backed by commercial/multifamily loans. In 2005, 2006 and the first 10 months of 2007, rating agencies made 9,140 ratings adjustments to CMBS, and for every one bond downgraded, 10 were upgraded. The bond performance—like that of the loans themselves—has been unprecedented (see Figure 7).

Equilibrium, dis-equilibrium and 'dat-equilibrium: The road ahead

Commercial/multifamily real estate finance is in a period of transition from a period we referred to last year as the perfect calm to its next equilibrium state.

What will that new equilibrium look like? To paraphrase former U.S. Supreme Court Justice Potter Stewart, we'll know it when we see it. In general terms, it will be characterized by a shared understanding within the market of what the going (not necessarily "right," but "going") prices, terms and conditions are for the sale/purchase of properties, loans and bonds.

Once reached, the new equilibrium may last a month, or a year, or a decade before moving on to the next dis- and then 'dat-equilibrium.

Looking ahead, a series of factors will affect the next equilibriums and the levels at which the market trades.

Equilibrium in the broader capital markets

The most significant factor currently affecting the commercial/multifamily real estate finance market is the eventual return of equilibrium to the capital markets. As the markets continue to work their way toward a new equilibrium, a significant source of capital for commercial real estate is sidelined. The result is, in the language of economists, a shifting supply curve that brings with it higher prices and tighter conditions.

Demand and the economic outlook

Another key factor is the overall economic outlook and the demand for space it creates. MBA's economic forecast projects an economy working through its recent challenges. Growth is likely to be positive, but slower, and interest rates will reflect continued macroeconomic uncertainty.

Two "take-aways" for commercial/multifamily real estate are that a) property fundamentals are directly tied to economic performance, and b) base interest rates should remain low in historical terms.

During the recession of 2001, retail properties performed well because consumers continued spending, office properties performed poorly as companies shed workers, and apartments performed poorly because—despite the recession—homeownership continued to siphon off rental demand (see Figure 8). The current economic slowdown is likely to slow the growth of demand across property sectors, and greater heterogeneity will again be seen between different markets. But absent a recession, commercial/multifamily property markets as a whole should continue to experience growth—albeit moderate growth—in demand.

Supply

The commercial/multifamily real estate sector's Achilles' heel has traditionally been new development. Over the last decade, and looking over the next few years, supply appears to have moderated. It is tempting to see this as the result of better information and risk management among construction lenders, but taking a sanguine, conservative view with regard to the risks of new supply is probably a healthy perspective.

Vive la différence

In recent years, the strength of the markets has meant a diminution in the differences seen among different property markets, property types, asset types, and the like. The coming year is likely to see a marked return to the importance of distinctions. As such, it is unlikely that buckets of assets—whether grouped by market, property type, rating or other distinctions—will perform in unison.

Refinances

A large share of commercial/multifamily mortgages does not fully amortize. To the degree market conditions are significantly different at their maturity than they were at origination, some existing loans may face challenges refinancing. The fact that many loans were refinanced in recent years has generally pushed much of this challenge out to future years (with the largest wave hitting eight to 10 years from now). But given that many recent loans were originated with near-record-low cap rates at near-record-low interest rates, depending on the conditions at the time of refinance, the stress on these loans could be significant.

Final thoughts

The commercial/multifamily real estate finance markets have hit a period of dis-equilibrium unlike any since the late 1980s. As the markets work through this period and the CMBS market seeks its new equilibrium, it will have effects on most aspects of the industry.

To some it will provide challenges; to others opportunities. To the industry as a whole, it marks a significant period of transition from one pattern of prices, terms and relationships to another. **MB**

Jamie 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.