

ten implications of the credit crunch

DUE TO LIQUIDITY AND VALUATION ISSUES surrounding securitized debt backed by sub prime mortgages in the US home market, an increased perception of risk on the part of lenders has spread throughout the global financial system creating the current "Credit Crunch." Below are ten of the possible implications for the commercial real estate sector.

1 Sales volume will drop until a new price level is achieved and friction between sellers and buyers eases.

Implication: Falling volume will result in less 1031 demand. Demand for 1031 properties will also soften as the gains on sales drop and more capital is reinvested into alternate asset classes.

2 A flight to quality is typically experienced during any period of market uncertainty.

Implication: Top assets in top markets will see less of a price correction than class B & C assets in secondary and tertiary markets.

3 Properties and markets that command the attention of institutional and foreign buyers will continue to have the most competitive bidding. Markets with buyers that have relied most on CMBS conduit financing will see investor demand fall.

Implication: Top assets in top markets will see less of a price correction than class B & C assets in secondary and tertiary markets.

4 Mega-deals and portfolio transactions have been primarily financed by Wall Street will be curtailed due to the credit crunch.

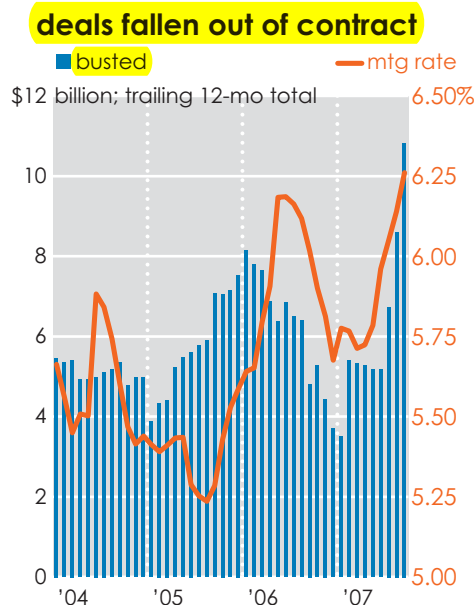
Implication: Pricing premium enjoyed for portfolios and other major asset sales will diminish.

5 Portfolio Lenders are regaining market share from conduits. For these lenders, sponsorship matters and a track record and proven operating abilities are highly preferred.

Implications: Sellers won't see as many new, out-of-state bidders. It discourages new investors plus some portfolio lenders do not like TICs or other complicated ownership structures.

6 With the amount of busted deals and re-trading that has occurred lately, sellers are favoring buyers with a high confidence of closing.

Implication: The highest bid may no longer win the deal. Sellers are favoring buyers with no financing contingencies and ones that can quickly make firm and non-refundable deposits. Institutions and other established, reputable buyers will be favored.



7 In the past, a 90- 95% leased building achieved prices close to that of fully leased buildings. Now buyers will have to put more equity at risk since their lender won't give them credit for vacant space anymore.

Implication: Prices for well leased properties will hold up well compared to those with current vacancy or heavy rollover exposure.

8 Just as construction costs were starting to stabilize and commercial development was gearing up, the credit markets have changed the economics again. Developers are facing higher financing costs and greater equity contributions even if they can get a loan.

Implication: New development will remain constrained which is a positive for the space markets. Of all the uncertainties in the market, the fear of overbuilding is not one.

9 Demand for mezzanine debt has grown as LTVs of first mortgages have fallen. With a number of mezz lenders clipped by the credit crunch, mezzanine debt has been significantly re-priced with returns back in the mid to high teens.

Implication: Yields on mezz debt are looking attractive compared to equity, and more private equity funds are contemplating filling this capital void.

10 As new mortgages are tough to get and terms are not as favorable, assumable debt will be sought by buyers.

Implication: Properties with mortgages originated over the past few years that are also assumable will trade at a premium. Institutions may find opportunities in assuming moderate leverage with mortgage rates that are now relatively low.

big picture: the price correction

UNTIL A NEW PRICE LEVEL IS ESTABLISHED, sales volume will continue to slow, more deals are likely to fall out of contract and more offerings will be pulled from the market without selling. Cap rates will most certainly rise, but the overall price correction is still yet to be determined.

Anecdotally, the most predicted impact on pricing is a 10% decline. If true, it corresponds well to the appreciation experienced in Q4'06–Q1'07 when underwriting was at its most aggressive. It is also important to note that the price correction underway will be highly selective, with certain properties and markets experiencing far greater weakness in pricing.

The current upward pressure on cap rates is considerable and comes from two primary but independent sources: the credit crunch and the rising potential for a recession.

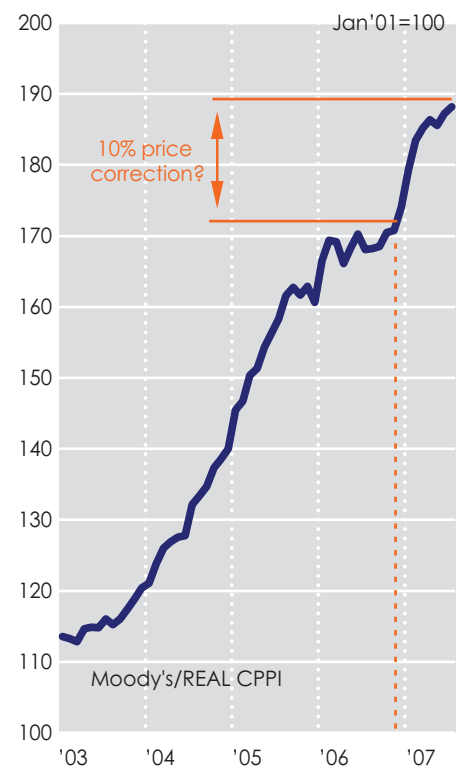
The credit crunch has made financing not only difficult to obtain but also more expensive. Even after liquidity returns it is likely that investors will still have to pony up more equity, pay amortization and perhaps fund reserves. **Leveraged**

investors are now operating under a different paradigm that does not allow them to pay as much as they could just a few months ago.

In addition to the impact of less favorable leverage, a potential recession is tempering prices for all buyers. With the surprising loss of jobs in August, fears of a recession spread and almost immediately all buyers, leveraged and not, scaled back on their rent growth and leasing assumptions. Low-to-moderate rent growth can no longer justify some of the low caps paid just a few months ago. The Fed sent a strong signal to fight recession but investors remain cautious.

As the new pricing level is established, it is important to take note that the amount of capital in the market remains considerable and few of the sellers seem pressured. Prices could prove to be surprisingly resilient and vultures may be disappointed. After all, it was only four years ago that prices actually improved as fundamentals deteriorated due to the quantity of capital in the market, and there is far more capital for commercial real estate now than four years ago.

commercial real estate prices



SOURCE: Moody's/REAL national index all property type composite, monthly