

Is the Commercial Real Estate Market Taking a Dip?



Commercial lenders are tightening their lending requirements.

By Jacob Yadegar

With the collapse of the subprime mortgage market, lenders are beginning to crack down on what they see as risky lending practices in commercial real estate.

Low interest rates and an abundance of money have led to great times for buyers and sellers of office buildings, hotels and other income-producing property. Buildings have traded at record prices and loan terms have become increasingly generous with many buyers putting little or no money into the deals.

Like residential loans, commercial mortgages are pooled and packaged into bonds that are sliced up into portions carrying different degrees of risk. According to rating agencies, there were \$769.6 billion in commercial mortgage-backed securities at the end of last year representing 26.1 percent of all outstanding commercial mortgages.

The agencies that rate these bonds on behalf of bond dealers have issued warnings in the past, but last month they sounded a new note of urgency. For the first time they said that they would adjust their ratings to reflect their concerns.

As concerns are looming about the state of the economy, many reports are now suggesting that commercial rents will begin to drop as demand for commercial real estate diminishes because of problems in the housing market and the economy.

Neither the possibility of a slowdown nor the warnings about lax underwriting standards have led anyone to predict an imminent catastrophe in commercial real estate. The default rate for commercial mortgage-backed securities remains quite low and is not expected to increase appreciably in the near future. In fact, Standard & Poor's, a rating agency, said that in the first quarter of this year, the delinquency rate for such

bonds fell to its lowest level since the delinquency index was created in 1999.

As was the case in the overheated residential mortgage market, many loans for commercial transactions are interest-only for the first 10 years, with huge balloon payments at the end of the term. The agencies say lenders are not requiring landlords to set aside adequate reserves to cover taxes, insurance and other costs if things go wrong and are accepting projections for rent growth that may be too optimistic.

Borrowers are also not taking precautions and may face severe problems down the road if they don't properly address risks associated with these aggressive loans. In fact, many may be faced with foreclosure and/or an inability to refinance as lenders tighten their requirements or rents don't continue to increase over time.

One example of aggressive underwriting was the \$7.25 billion purchase of eight Midtown office buildings that had belonged to Equity Office Properties before Equity was sold to the Blackstone Group in what was then the largest leveraged buyout ever. The average annual rent for the buildings is \$55 to \$59 a square foot, but the deal was underwritten with projections of future rents of \$100 a square foot or more.

If this trend continues, it's only a matter of time before the commercial mortgage market plummets like the subprime residential market. Prudent financing and planning are critical in protecting your assets to insure long term prosperity.

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