



Commercial Real Estate Market Conditions and Lending Remain Strong

By

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On June 20, the Portfolio Investors Committee Senior Executive Roundtable featured a lively discussion on current commercial real estate market trends and alternative real estate investment opportunities. Sam Chandon, PhD, Chief Economist and Senior Vice President of REIS, led the discussion on commercial real estate market trends and Paul Hughson, Managing Director of Lehman Brothers discussed alternative debt investment strategies. The meeting was held in Chicago and was hosted by Joseph Burke, Managing Director of PPM Finance and Vice Chair of MBA's Portfolio Investors Committee. The Roundtable meeting involved lively participant discussion throughout the meeting.

The session began with a presentation by Dr. Chandon of the latest economic and commercial real estate market trends. Dr. Chandon indicated that GDP growth at an annual rate of 5.3 percent in the first quarter of 2006 will likely moderate to below 3.5 percent for the year. During the first quarter of 2006 other economic indicators were strong such as consumer spending increasing at an annual rate of 5.5 percent, durable goods purchases increasing at an annual rate of over 20.0 percent, and business investment that rose at an annual rate of 14.0 percent. The first quarter unemployment rate of 4.6 percent was another indicator of the economy's strength. Clouds on the horizon are record low consumer savings rates declining consumer confidence.

Dr. Chandon also examined apartment, office, retail, and industrial market trends. Modest supply growth coupled with increasing demand is project to cause a decline in the vacancy rate from 5.8 percent in 2006 to 5.3 percent in 2010. Dr. Chandon forecasts tight supply conditions to support effective rent increases of 3.0 percent in 2006, 3.2 percent in 2007, and 3.4 percent in 2008. For the office market, Dr. Chandon projects net absorption to outstrip new completions over the 2006 to 2010 period, resulting in the vacancy rate declining from 13.7 percent in 2006 to 10.5 percent in 2010. During this period effective rent growth is projected to range from 4.1 percent to 4.4 percent.

For the retail sector, Dr. Chandon forecasted additions to supply to prevent the decline in the vacancy rate. In fact, over the 2006 to 2010, vacancy rates are projected to remain relative stable, only ranging from 7.0 percent to 7.2 percent. Effective rent increases are also forecast to be relatively stable, only ranging from 3.1 percent to 3.3 percent during the 2006 to 2010 period. However, Dr. Chandon cautions, “rising interest rates in an environment of high household debt, a cooling housing market, and volatility in energy prices have the potential to weigh on the sector by eroding consumer spending power”.

After a dramatic slowdown between 2001 and 2003, the industrial market is project to continue its recovery during the 2006 to 2010 period. Vacancy rates are projected to decline from 9.4 percent in 2006 to 8.6 percent in 2010. Projected effective rental rates increases will range between 3.2 percent to 3.6 percent during this period.

Paul Hughson provided an overview of the commercial real estate finance market and innovative structures for participating in commercial loans. Mr. Hughson began his presentation by discussing general market trends in commercial real estate finance. The Lehman Brothers Whole Loan Index shows spreads declining from Treasuries from 200 basis points during 2001 to 100 basis point in 2005. An attractive feature of CMBS for investors was for the December 2004 to December 2005 period, was CMBS default rates that were significantly below corporate bonds, 1.8 percent for Ba corporates versus 0.0% percent for CMBS and 2.8 percent for B corporates versus 0.4 percent for CMBS.

Mr. Hughson discussed a variety of commercial real estate investment vehicles made available by Wall Street firms that include: real estate equity co-investment, B-notes and mezzanine debt, and co-origination. Equity co-investment involves working with the Wall Street firm to purchase commercial real estate assets. The advantages of equity co-investment is that it allows for an alignment of interests with investment partners, simplicity of pre-packaged transactions, eliminates pursuit costs and time, transparency of structure, not a blind pool.

Mr. Hughson indicated that B-notes and mezzanine debt had the following advantages: life companies have existing in-house capacity to perform the due diligence, provide higher rate of return than whole loan market by leveraging exposure, ability to set size of investment, and ability to direct work-out situations. Co-origination involves the originating of a loan where the investment grade portions of the note are securitized and the co-investors hold the B-Note. Retaining the B-Note allows the financial institution to lever its return and by retaining servicing rights become the primary point of contact for the borrower. Mr. Hughson also indicated that Wall Street is providing funding for land development, which had historically been the province of regional banks.

For additional information on MBA's Portfolio Investors Committee and its forums for senior commercial and multifamily real estate lenders, contact George Green at 202/557-2840 or ggreen@mortgagebankers.org.