

GUEST COLUMNIST

Where Did the Money Go?

BY MARK C. RITCHIE

This indeed is a frightening headline but not completely unexpected. As 2007 began the real estate community was awash in capital with market participants crowing about how the sky was the limit. To paraphrase a quote from "The Wizard of Oz": We're no longer in Kansas!

For 2008, we believe there are five interrelated themes that will not only impact the way we do business, but will set the industry's tone and direction.

Gone are the 1.0x debt coverage, interest-only deals for 10 years. Today projects are being underwritten at traditional debt coverage ratios with amortization and a focus on lender exit.



RITCHIE

Availability of Capital

It is important to differentiate between securitization, such as Wall Street and commercial mortgage-backed securities, and portfolio or on-book lenders, such as banks and life insurance companies.

The impact of the current credit crunch is a worldwide phenomenon and until the larger problems are worked through, that is a clean up of lenders' balance sheets, financial markets will continue to be treacherous. It is fair to state that the life insurance companies' and banks' — those with limited CMBS/non-prime exposure — balance sheets are in good shape.

Unfortunately, for all participants the current situation translates to a higher cost of capital. A recent poll of Wall Street originators indicated that, on average, they believe that CMBS' return to the markets won't happen until third-quarter 2008 at the earliest.

Portfolio lenders active in the current environment are focused on attaining attractive spreads and/or improving market share.

Not to be outdone, banks have taken business from both CMBS sources and life insurance companies. There is concern from some portfolio players about whether they will have capital to lend because some portfolio lenders are closed for business.

Other participants believe this environment is a natural swinging of See RITCHIE, page 19

THE NEXT LEVEL
FINANCE

LONG-TIME DEBATE
OVER PREVAILING WAGE
CONTINUES IN VISTA
PAGE 17

RITCHIE

Continued from page 1

the spread "pendulum" and that spreads will remain wider as they have been too narrow the past few years.

Battle Between Sellers and Buyers

Early results in this battle indicate that high-quality institutional deals have seen slight upward movement in capitalization rates, while acquisitions with risk, secondary locations or average asset quality have seen their capitalization rates move up significantly.

According to one of our Wall Street participants, capitalization rates will have to move upward by nearly 200 basis points for buyers to enjoy the same "projected" returns as a year ago.

Reemergence of Traditional Finance Players

The past few years have been a boon for Wall Street, which was hyper-competitive on most product types, including low leverage, high leverage, value added or financings calling for significant flexibility. With Wall Street effectively sidelined, the traditional real estate players are making a comeback. Until now these sources could not compete at what they viewed were unprofitable spreads. This group includes value-added and mezzanine lenders, portfolio lenders and banks. Today, they are well positioned to provide capital, albeit at a cost. This will inevitably impact capitalization rates and values. Most importantly these providers are focused on actual, not proposed, cash flow.

Creativity

The CMBS world has forced change on all industry participants. Wall Street had taken away the traditional 10-year mortgage from the portfolio lender. However, the sources and needs of portfolio money have also changed. We have seen an increase in the variety of products from traditional life insurance companies, including fixed-rate construction and permanent loans to creative prepayment structures to variable-rate financings. Not to be outdone, banks have become very competitive with their long-term products. We are seeing finance companies partnering with others to provide A/B structures — that is, traditional lenders — life insurance companies and banks — and real estate finance companies working together to provide these creative structures.

The bottom line is that going forward, those best able to harness these innovations will prosper. Commercial real estate today is generally sound and if market players are able to adapt, the industry will successfully negotiate through this rough terrain. 🏠