

# THE REAL DEAL

September 2007

## Building prices poised for a drop-off

*Subprime default threat spreads, threatening commercial deals in city*

By The Real Deal staff



SL Green announced its purchase of most of the land beneath the Lipstick Building at 885 Third Avenue at the height of volatility in the commercial market.

The ripples of the subprime mortgage debacle continue to widen, and market watchers worry that its consequences will soon spread beyond poorly qualified home buyers to affect commercial real estate values in Manhattan.

The connection between shuttered subdivisions and sagging skyscraper prices goes back about a decade. In the mid-1990s, a few mortgage lenders began securitizing both residential and commercial loans -- meaning they would pool the loans together and then sell them as packages to investors in a secondary market. There they would often find their way into multibillion-dollar investment pools known as collateralized debt obligations and collateralized mortgage obligations (CDOs and CMOs), which are generally owned by institutional investors and hedge funds. Few had any idea where the newly created market for these securities would lead.

But as many subprime mortgages slide into delinquency, the worth of these securities pools, which are already hard to value, has been thrown into question. The outcome of recent uncertainty in the capital markets is still unclear, though several high-profile hedge funds at Bear Stearns and Goldman Sachs have required bailouts.

### **Crunch hits credit pools**

In the debt markets, credit is drying up and getting more expensive. Many real estate insiders said money lenders have become more conservative. Though it hasn't happened yet, that could ultimately affect the valuations of commercial buildings since buyers will pay higher interest, ultimately curbing the ability to pay high asking prices.

"To the extent that people who want to buy real estate have a tougher time getting loans and wind up paying higher rates for the money they use to buy real estate, it's inevitably going to have a negative impact on property values," said Scott Tross, a partner based in Newark at the

law firm Herrick, Feinstein LLP, which has one of the largest real estate practices in New York City. This is because buyers will want to pay less since they can't borrow money as cheaply as before.

"The only question is, 'How long is this going to continue -- three months, a year, two years?'" Tross asked. "Nobody can tell you the answer."

Banks' enthusiasm for securitizing and reselling their loans created a boom in the CDO and CMO market, but its glory days ended abruptly. The commercial mortgage-backed securities market faltered in February and was further weakened by an April report by Moody's Investors Service concluding that underwriting standards for many of the securitized loans had become very lax. The market for mortgage-backed securities had largely dried up by mid-summer.

Subprime mortgage-backed securities were derailed by rising default rates, and when those valuations were thrown into question, so was the high credit quality on other pools of real estate securities. Those same debt rating agencies -- such as Moody's, Standard & Poor's and Fitch -- graded commercial loans, which had also been combined and sold as commercial mortgage-backed securities.

Many investors began to ask questions about risk -- could the ratings agencies be wrong? Many lenders such as investment banks, whose sole purpose it was to make loans for securitization, began to pull out of lending or tighten their lending terms, brokers said, for fear of being unable to resell their securities pools.

### **Constraining commercial activity**

That has driven up the price of money for both residential and commercial development and purchases, even among traditional banks, which now can call the shots about loan terms. This has happened even in the absence of defaults on the commercial loan side, brokers said.

"There's already talk of people having trouble financing transactions just because they're unable to sell or resell buildings they've purchased," said David Tobin, principal at Mission Capital Advisors, a boutique investment banking firm based in Manhattan.

Most are realistic about the prospect of the commercial side taking some blows in a shifting market.

"Anybody who pontificates that the commercial property market is somehow different and impervious to a downtick or a devaluation or a change for the worse is crazy," Tobin said. "As goes the residential mortgage market and the stock markets, so too will go the commercial property market, and the financial market supporting it."

Tobin said he believes that this slowdown will ultimately affect the valuation of buildings, particularly residential buildings, in New York City.

Strong fundamentals in New York City "may delay the decline, but just the amount of supply of very high-priced apartments that are coming online will definitely have a downward effect on pricing and land prices," Tobin said.

Tobin said he is also worried about Wall Street bonuses, which typically fuel the purchase of condominiums and co-ops in the earlier part of the year. While the sale of those luxury

apartments may be small in proportion to the rest of the Manhattan market, there may be an impact, he said.

"I think the really abrupt slowdown in mergers and acquisitions and corporate finance activity in the city are going to have a real impact on bonuses," which will be felt in early 2008, Tobin said.

### **Tightening the purse strings**

Most experts in the field of real estate finance said the freezing of capital flow associated with subprime mortgages and commercial mortgage-backed securities is providing an opportunity for more traditional and conservative lenders to not only get back into the market but to call the shots.

Traditional banks are "much more conservative, but they're being approached more and more," said Wayne Heicklen, a partner and co-chairman of the real estate department at Pryor Cashman LLP. "They require a lot more equity in the deal. Maybe they require some recourse. And their pricing is slightly higher, but all of a sudden they are the only game in town."

Scott Singer, an executive vice president with the Singer & Bassuk Organization, a mortgage brokerage, said that he believes property prices are holding and that some lenders see the growing conservatism of other lenders as an opportunity to be even more aggressive.

"There are certainly some significant capital providers who have gotten much more conservative, and yet there are others -- and I'm having discussions with them on a daily basis -- who are remaining very aggressive," Singer said.

"Everyone is lending at higher spreads than previously, and some of those rising spreads have been offset by a drop in Treasuries, but not all of it, so the borrowing costs are higher. But we're still in an environment where some players are seeking to take advantage of the conservatism being shown on the part of many lenders in order to lock up a lot of business," he said.

Singer said that if the real estate fundamentals in Manhattan remain strong, the mortgage predicament should remain just a blip.

"On the negative side, however, depending on whether the credit crunch turns into a credit crisis and liquidity really does dry up [and] the more aggressive lenders get less aggressive, that will clearly have a negative affect on property prices," he said.

Richard Bassuk, president of Singer & Bassuk, said that to close some recent deals, he has been able to convince some conduit lenders looking to securitize loans to move forward and agree to keep the loans in their portfolios if they can't sell them.

"There are lots of different lenders and liquidity in the market, but they have to feel comfortable that the ultimate credit markets are working," Bassuk said. "That will take a period of time."

### **Deals get extra pushes**

Bassuk said late last month that the current uncertain market would be a good one to wait out, until Labor Day and most likely beyond, to some extent.

"This may take some properties off the market, if people see they can't get the highest prices for properties now," he said. "If they're not under any pressure to sell, if I were that seller, I might

hold on to the building. Similarly, with land prices, I'm not going to give my land away. I'll get my price tomorrow or the day after, and sometimes that day after is a couple of years."

### **Other mortgage brokers agreed.**

"I don't see the valuation of assets coming down just yet, because sellers' expectations have not reached buyers' expectations," said George Stergiopoulos, a director at Cooper-Horowitz. "Probably for the next two quarters, we'll see a wait-and-see game."

However, despite lenders' requiring buyers to put more equity into deals, transactions are getting done, he said. A case in point is SL Green's purchase for \$317 million of most of the land beneath the Lipstick Building at 885 Third Avenue, announced in July at the height of the volatility in the commercial market. SL Green, along with its lending arm Gramercy Capital Corp., will control 79 percent of the fee portion of the building and 21 percent of the leasehold portion.

"Buyers are starting to get creative," Stergiopoulos said. "That was actually a way of the buyer shoring up their equity position, so they didn't have to raise as much money. So creative things are happening, and you'll probably see more of that."

Things move much more slowly in the real estate investment sales market than in capital markets, brokers said, so the fallout of the subprime mortgage debacle will not immediately be felt. It may be confined to overhauled underwriting standards on the part of lenders and increased scrutiny of ratings agencies, or it may lead to defaults on commercial loans, but no real estate insiders ventured to guess at this point.

"Loans have been made over an extended period of time with loose underwriting, and the question going forward is going to be, 'How many of those loans go into default?'" Tross said. "You're not going to find that out immediately, but going into 2008 and 2009, it's going to be very interesting, because with some of these loans, there's really no margin for error. Say the loans mature, and the holders need to refinance. If property values have dropped, they may not be able to refinance all their debt.

"If anything goes sideways in the commercial market, and the market is notoriously cyclical, it will be interesting to see how many of these loans fall out of bed."