

THE REAL DEAL

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House of cards comes tumbling down

From hesitancy to headaches, how subprime fallout will affect city's real estate pros

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Since delinquencies among subprime loans that had been packaged and resold on secondary markets reached fever pitch this summer, there have been tremors in not only the New York City residential real estate market, but in the thriving commercial one as well.

The era of cheap credit has unraveled quickly, as a crackdown on risky loans has tightened standards among all lenders. The fallout has affected all parts of the New York City real estate food chain. It's hit residential sales brokers, some of whom have seen their deals jeopardized

as lending terms change and interest rates rise, as well as developers of office buildings, who are finding it more difficult to obtain financing from lenders.

Others, like commercial brokers, real estate attorneys and new development marketers, have also felt an impact. The Real Deal set out to capture the reaction to the subprime mortgage debacle and credit crunch from individuals on the front lines in several sectors of the New York City real estate industry.

Residential brokers

Leonard Gottlieb, an associate broker with Halstead Property, was ecstatic that the two-bedroom co-op apartment at the Grinnell at 800 Riverside Drive sold. All that was left was the closing. On July 31st, all the necessary parties were at the negotiating table to close the deal. All except one, that is: the lender.

That was the day American Home Mortgage had stopped lending on its approximately \$450 million worth of commitments. The closing quickly adjourned.

"The buyers were devastated and began scrambling to get another mortgage," Gottlieb said. "But apparently, a week after the closing had adjourned, the bottom line was that no bank was going to give them the same terms, and that would throw off their budget. They were not able to secure a mortgage, and they backed out."

Gottlieb, who has since put the classic six at the Grinnell back on the market for an asking price of \$875,000, said he was shocked that he and all those involved, including the buyers taking out

the jumbo loan (or one for more than \$417,000), became the victims of the subprime mortgage debacle.

"The attorney for the buyers said in 40 years in practice, he'd never seen anything like this," Gottlieb said. "Even the co-op board was amazed. You'd think New York City, and Manhattan specifically, is immune to this, but this affected us directly."

Gottlieb said he learned a lesson the hard way with the failed transaction.

"Even though the buyers are board-approved, you have to look at what kind of loan they're going after," he said. "Also, who is the lender, and are they stable? Because you're hearing buzzes about Countrywide Financial, etc."

In recent weeks, Countrywide Financial Corp., the nation's largest mortgage company, was subject to investor worries about its ability to fund its business, raising concerns about the health of the company and the industry at large. In a move that helped to blunt those concerns, Bank of America Corp. on Aug. 22 acquired a \$2 billion equity stake in Countrywide. The move provided some liquidity and stability for Countrywide, whose stock price had fallen more than 50 percent for the year to date on the day the deal was announced.

Since the buyers in the scenario should have qualified for another mortgage, Gottlieb said the broker should "make sure the buyer is truly qualified for a few scenarios -- that they're not just on the edge -- in case something changes."

Most residential brokers are not feeling the effects of the subprime mortgage crackup in such a direct fashion. Mostly they are feeling it as a "chill" or a "freezing up" of the market as buyers and sellers wait to see what will be the outcome.

"On the sales and acquisition side, we have seen kind of a stop," said Vincent Nicoletta, president of Pari Passu, a full-service real estate brokerage. "Prices have remained steady. But people aren't getting pre-qualified for mortgages anymore, and it's harder to get 80 percent financing -- let alone the 90 percent financing people were traditionally getting -- meaning buyers have to come up with more equity. If you have to come up with more cash, that means there are fewer people out there to buy apartments."

Since the situation only came to a head in July, those in the real estate market have taken a wait-and-see attitude, Nicoletta said.

"There hasn't been a lot of movement in either direction," he said. "Sellers are not lowering their prices, and buyers are not jumping at buying stuff. It's kind of like they're saying, 'Let's see if this credit crunch is just a short-term blip.'"

On the residential rental side, where most of the 60 brokers at Pari Passu were doing business in mid-August, the market couldn't be better, Nicoletta said. The rental market in Manhattan, which had a vacancy rate of 0.81 percent in July, according to Citi Habitats, could benefit marginally from the subprime mortgage scourge, he said.

"People who are currently renting and thinking about buying, obviously, they're going to stay and re-up for another year, or move into a bigger rental place, either because they can't afford to buy now or they're a little scared to buy," Nicoletta said. "So the rental market will continue to be hot in New York City."

New development marketers

New developments may not fare as well, though marketers are often loath to admit it. Marketers of new residential projects said that though they may have sensed a hesitation in the marketplace since news of the subprime mortgage delinquencies hit, the pace of sales continued to be normal for August, which is typically slow anyway.

"We're still actively selling," said Jacqueline Urgo, president of the Marketing Directors Inc. "There are still bidding wars, so savvy people are still moving forward."

Tightening lending terms on the part of banks and lenders could become an issue, marketers said, with the most vulnerable sales currently being the ones in process. Urgo said most of the units being promoted by the Marketing Directors are now in presales, so buyers haven't even gone for their loans yet.

"They're not necessarily closing imminently, so this hasn't had a direct effect on us," she said. Still, the Marketing Directors is taking no chances and has forged an alliance with Wells Fargo.

"They've come up with a program for us that guarantees the closing date," Urgo said.

Some banks have been boosting interest rates as high as 8 percent on jumbo loans, she said, and appraising properties at lesser values than they had comparable properties in the recent past. Lenders have also been changing the terms of loans, so the Marketing Directors has also sealed a deal with Wells Fargo to "come in and take over for a loan that's having a problem," Urgo said.

Banks that hold their own paper (or don't syndicate and sell off their loans) are still offering rates of 6 percent, Urgo said.

"People are still committing to very expensive homes, and we're selling all of our new construction product without mortgage contingencies," or without a clause that allows an aspiring buyer to get the deposit back if they can't find a lender, she said.

Nancy Packes, president of Brown Harris Stevens Project Marketing, said she's seen no change in buyer interest. She said the ultimate effect of the subprime mortgage fiasco has actually been to create a favorable borrowing climate for typical Manhattan buyers.

"The Manhattan and nearby county buyer profile tends to be an extremely affluent individual or family with excellent credit," Packes said. "They seem not at all affected in obtaining mortgage lending. If anything, they seem to be more sought-after by the banks now," because banks perceive them to be low-risk borrowers and "because of the ability to easily package their loans and sell them within the collateralized mortgage system."

Contrary to what others in the industry have observed, Packes said she has not experienced higher rates.

Developers

As developers look for loans or refinancing, rumors swirl that some projects have stalled for lack of money. The Internet has aided and abetted these concerns. Shaun Osher, founder and CEO of Core Group Marketing, has already had to mount a counteroffensive on behalf of one such project, the Onyx Chelsea, at 261 West 28th Street. The agent said talk of a financing collapse is completely unfounded.

"We have two units left, and the building is getting its TCO [temporary certificate of occupancy] imminently," Osher said. "With respect to new developments, if people have a construction loan, and the building is going up out of the ground, this [subprime mortgage predicament] is not going to affect the development."

Osher said banks are definitely slowing down their financing of new projects, and some are closing their doors to new construction loans and financing.

"If there is going to be an effect on the market, we'll see it six months to a year from now, when developers who might be buying sites today don't go forward with their purchases," he said. "I actually see this having a positive impact on the market, because it will control the amount of inventory that we're going to be seeing flooding the market" in New York City.

Developers said that due to the subprime mortgage breakdown, all lenders are tightening their belts, and that's affecting both the residential and commercial property development market. It's also hampering investors trying to purchase buildings. Though the rules of the game for acquiring capital for development have changed, that doesn't necessarily portend disaster.



"Quite frankly, I see opportunity for companies like ours, who have historically been more conventional with the financing, not playing the different games of the capital stack and looking to squeeze out every last fee," said Daren Hornig, a managing partner of Saxa Inc., a developer that started out specializing in office condominiums but has since gone on to diversify into many other areas of development.

"We're going to put real money down; it's our money," he continued. "We're not going out to private equity pools, typically, and looking to leverage that money and bring in mezzanine debt."

In the current market, the real estate deals will become more about real estate asset value and less about creative financing, Hornig said.

"This definitely limits the number of buyers, because you don't have unlimited financial resources," he said. "But it also brings sanity to the market. Those people will be normalized buyers, and people will think twice about selling an asset now."

Hornig said that he has not as yet seen a change in building or land values, but he predicted there is one in the offing.

"You're not going to see sales values change that quickly; however, I'm sure they're changing, because the underlying economics can't justify creatively leveraged transactions now," he said.

Another change that might take place, Hornig said, is increased examination of ratings agencies, which gave acceptable ratings to the packages of subprime mortgage-backed securities that eventually tanked. Those same ratings agencies graded loans for purchases of commercial buildings, which had also been combined and sold as commercial mortgage-backed securities for many years, he said.

These agencies "are currently rating the debt more closely, because I think there's going to be a lot of scrutiny and a lot of headlines about these ratings agencies, and what they didn't do the last five years," Hornig said. "They were just rating everything at a level that seemed to be somewhat acceptable when, clearly, it's horrible. I think you may see some legal actions and investigations of these ratings agencies."

Developer David Lowenfeld, an executive vice president at World-Wide Group, said residential developers may be hit on two levels. First of all, residential projects under way may be affected as residential buyers make a "flight to quality," especially those in the jumbo loan category, where lenders are pulling back and charging higher interest rates.

"Buyers will be more cautious, due to their ability to finance, about going to emerging neighborhoods," he said. "They may opt for fewer square feet in an established neighborhood rather than more in an emerging neighborhood."

For Manhattan buyers looking at premium apartments in top-notch locations seeking to purchase without a lot of leverage, there will not be much of a change, Lowenfeld said.

"But in emerging markets outside of Manhattan where buyers are looking for high leverage, there will be fewer buyers, and prices will come down," he said.

World-Wide Group is constructing an apartment building with large units at 255 East 74th Street. It's about 40 percent sold. Lowenfeld said he wasn't worried about buyers acquiring financing, and since the subprime mortgage crisis erupted, none have shown up trying to get out of their contracts.

"They won't get financing until they're ready to close," he said, "and they're years away."

Like Hornig, Lowenfeld said the subprime mortgage crunch should only affect those property developers who need highly leveraged loans.

"The undercapitalized developer is the loser," he said. "The winner is the well-capitalized group that is ready to take advantage of opportunities in the marketplace."

Mortgage brokers

Mortgage brokers, intermediaries between buyers, building investors, property developers and lenders, are dealing directly with the fallout from the subprime mortgage calamity.

Some residential mortgage brokers have seen a bit of a holdup in their business as investors try to determine how the real estate bonds on the secondary market are rated, what they are worth, and whether they want to purchase them, said Ken Evans, a senior vice president at Preferred Empire Mortgage, the mortgage brokerage arm of Prudential Douglas Elliman.

"The product that's having an issue selling right now is the jumbo mortgage," Evans said. "Those were put into mortgage-backed securities and sold on the secondary market. The conforming loan, which is the \$417,000 or less loan, is sold as well, but it's sold to Fannie Mae and Freddie Mac, which are quasi-government entities. Those loans are not affected nearly as much as the jumbo market."

Even though the subprime mortgage crisis might not appear to have direct links to the commercial market, illiquidity has also had an impact there as well. Brokers who deal with those

seeking loans for commercial land or building purchases have found themselves retreating to their Rolodexes.

Paul Talbot, a principal at Newmark Knight Frank who handles commercial mortgage financing, said now is when contacts with insurance companies and balance-sheet lenders are particularly important.

"Before, there was so much money out there, it was finding the best deal; it was conduit money [or money from banks that sold the loans]," Talbot said. "Now, it's going back a number of years to relationships. I look at this as an opportunity. The strong will survive."

Both Talbot and Nicoletta, who brokers commercial deals at Pari Passu, said that while residential deals often have mortgage contingencies, allowing the borrower to retrieve their deposit should the lender back out, commercial deals do not. In fact, banks that syndicate their commercial loans and sell them on the secondary market often have a "material adverse change clause" in their commitments in their applications, Talbot said.

That clause means that if something upends the marketplace, the lender could change the terms of the deal, he said.

"That's what concerns people," he said, "because if someone's buying something or refinancing, they want to know that the deal they've agreed to is the deal they're going to get."

Nicoletta said he recently experienced such a bait-and-switch with a client who was lined up to purchase a building in the tri-state area.

"We had a commitment with the bank, a big-name bank, and they came back and said, 'We're not going to lend you as much money as we told you originally,'" he said. "A week before the closing, they came and cut us by 15 to 20 percent, and then at the day of the closing, we had a rate-lock agreement, and they really had no basis to raise the interest rate, but they said to us, 'Look, we're not going to close unless you pay us a higher interest rate.' We had no choice."

Still, for those commercial borrowers looking for loans under about \$100 million, there still seems to be a fairly constant market, said Stuart Bruck, director of mortgage brokerage for Time Equities.

"There appears to be an ample supply of lenders for the small- and mid-range loans, including some of the commercial mortgage-backed securities lenders, but there are also life insurance companies, and at least here in New York City, the banks are very active," he said.

Banks have increased their spreads due to the subprime mortgage imbroglio, but some real estate insiders do not believe that will hurt borrowers.

"The biggest bump that I've seen from some of the area banks is that maybe they've increased their spreads by a little bit," Bruck said. "Maybe they've gone up 10 or 15 basis points, but that has been more than offset by the drop in Treasuries."

Lenders

Lenders are on the front lines, handling triage when it comes to the subprime mortgage crash, and some may be partially to blame for the crisis.

Residential lenders with flush balance sheets have traditionally done more conservative lending and are therefore flexing their muscles. Or if lenders are hybrids, both holding some loans and selling off others, they may be preparing more and more loans to hold in their portfolios -- at least until the subprime mortgage debacle has run its course.

Lenders are being creative and seeking ways to make their loans attractive to quasi-government entities, such as Fannie Mae and Freddie Mac.

"We have immediately started to try to get income from people who in the past we might have put into 'no income' [loans that don't require the borrower to document their income] because it was easy," said Michael Moskowitz, founder and president of Equity Now. "So now if you do have income, and you have reasonable assets and loan-to-value, you may qualify for Fannie Mae. So Fannie Mae and Freddie Mac have been a tremendous help."



Equity Now has also started doing some Federal Housing Administration loans, but those have even lower caps than Fannie Mae and Freddie Mac, where caps are at \$417,000 for a one-family home, condo or co-op apartment, he said.

Moskowitz said that Equity Now, which often sells off its loans on the secondary market, is also holding some subprime loans that it considers to be good risks. Still, while those loans may have had an interest rate of 8.5 or 9 percent six months ago, now the interest rate is more like 12 or 13 percent,

he said.

The possibility that a handful of subprime mortgages going into default could have ramifications for the entire real estate market signifies something about future real estate values, Moskowitz said.

"I think what's moving this is a general feeling that real estate values are dropping, and by the time you come to foreclose on this loan, you're going to be out," he said. "Since 2004, in my opinion, real estate values have been pushed up artificially by the availability of more and more exotic loans ... and it's going to come crashing down. I think in the next two or three years, real estate values are going to drop an additional 10 to 20 percent."

Some bankers said it will take time for the complexities of the market to unwind, as those who hold securities purchased from such banks awaken to their worth or lack thereof.

"The huge inventory of all types of asset-backed and leverage finance deals both pending and already 'hung' on bank balance sheets ... insures that this will take time to unwind and is likely to cause significant pain for those in highly leveraged or speculative positions of any kind," said Gino Martocci, a senior vice president who leads commercial and real estate lending in New York City for M& Bank.

Some shorter-term lenders may find the tumultuous market advantageous. As some property owners find themselves unable to refinance because of volatility in the market or some developers can't scrape the equity together to get acquisition or renovation loans, some lenders, such as BRT Realty Trust, a public company, will step in to provide unconventional loans.

"When there's acquisitions and transactional business, we're very active in that kind of market," said Jeffrey Gould, president and CEO of BRT Realty Trust. "Even though there may be problems out there, if people are buying, for example, bank debt at discounts, and are willing to get out of their own properties at reduced monies than what are owed, we sometimes finance guys that are buying back their own debt at discounts."

Commercial brokers

Property sales brokers on the commercial side said the prevailing wisdom currently when it comes to investment sales is "wait and see."

"Our business is often done on an auction basis, and there has been some reaction to these market conditions that would suggest any auctions concluding in [the last two weeks of August] actually be deferred to September in the hopes that there will be more clarity to the situation, and that lenders will not be putting up a red flag, which they're doing," said Stuart Gross, an executive managing director at Eastern Consolidated.

Gross said that Eastern was concluding an auction in mid-August for a development site on the East Side, where the final sales price was about \$500 a buildable square foot.

"That would be a very aggressive price, given what condo sales are in that marketplace," he said. "It looks like somebody's willing to put up a 20 percent hard deposit, and that would be a real deal. So it's not like people are running for the hills."

The pool of buyers may be shrinking, but there are still plenty of buyers and sellers in the marketplace, he said. "The people who can afford to put down very substantial down payments and carry these properties with that much equity are more likely to be the purchasers. Ultimately, it's got to impact pricing, but at the moment, we haven't seen it."

Brokers on the commercial leasing side said subprime woes may eventually affect the pace of leasing transactions, but were less certain that it would drive down office rents.

"If companies' profits are lowered as a result of it, the subprime mortgage meltdown could eventually affect the pace of leasing," said Bill Montana, a managing director at Studley. "But as it stands, New York City has a fundamental lack of space, with not a lot of new product under construction currently to meet demand, so it will take a longer period of time for prices to drop."

Montana said that landlords operating in one of the strongest markets in living history would rather take any of several other measures before lowering office rents.

"First, there's a waiting period," he said. "Then, if things don't get better, landlords try to ratchet up concessions, such as providing more free rents and more of a contribution toward construction. Only as a last-ditch effort do they finally, after a period of time, lower rents. It's never an immediate reaction."

Even if the financial industry in New York City takes a hit as a result of the adversity in the subprime mortgage market, Montana said he didn't believe it would create enough new office vacancies to have much of an effect.

Hedge funds "are not huge space leasers," he said. "Even if you had a whole bunch of hedge funds go out of business or put their space on the market for sublease, the buildings where they're located can absorb that space pretty readily."

But while hedge funds aren't big space users, they do help push up rents.

Moves by financial giants could also shake up the market. Last month, Lehman Brothers' decision not to take an additional 70,000 to 80,000 square feet at 399 Park Avenue sent a shiver through the commercial rental market. There are concerns that more financial firms will give up space as well.

Projected population growth in New York City, and the lack of housing and office space, should shore up the market in the long term, but the short- and mid-term may still be hard to chart, Montana said.

"If demand slows, and it stays low, just as new space hits the market -- such as the World Trade Center site, Brookfield's site on the West Side, Boston Properties' site on the West Side, and others -- then the market could certainly have a correction," Montana said.

But it is more likely right now, given the current conditions, that tenants will simply bide their time, he said.

"They'll try not to make a decision if they can," he said. "If they can't take a breather, they'll be more measured and prudent in their leasing: Instead of taking space in a trophy building, they're going to go in a more sensible building, and instead of taking additional space to accommodate growth, they'll take just what they need."

Marisa Manley, president of Commercial Tenant Real Estate Representation Ltd., said that, indeed, certain tenants that can afford to are putting off space renewals and moves.

"The same tenants who were eager in January to try to do a renewal and were saying, 'Let's get locked in, because I don't want to have to do this in 24 months,' are now saying, 'You know what? Twenty-four months from now, the market might be pretty good for tenants,'" she said. "There may just be fewer of these hedge funds around, and there may be a dip in the job market, and there may be more vacant space."

Still, Manley said the attitudes of landlords currently have not yet begun to reflect any possible fallout from the subprime mortgage debacle. "Do we see it reflected in today's rents and landlords' attitudes? No," she said. "Do we see some tenants anticipating there's a possibility? Yes."

Real estate attorneys

Lawyers who handle real estate transactions said they haven't yet experienced a slowdown in the pace of deals or had to do any fancy legal footwork to keep negotiations from heading south.

"We have a lot of clients out there wondering what's going on in the world, but almost all the deals we've been working on have been closing, which is always the question when there's a credit crunch," said Carl Schwartz, a partner and chairman of the real estate department at Herrick, Feinstein LLP.

Schwartz said he remembered that the last credit crunch was the "Russian crisis" in 1998, which evolved into a more severe situation than today's market troubles.

"There were a bunch of lenders who just did their best to pull out of deals, and deals didn't close," he said. "That hasn't happened. From what I understand, there are a lot of cash buyers out there, and leverage is still available, but at a lesser rate."

Schwartz said his law firm hasn't experienced any reduction in the pace of deals, but any subprime mortgage fallout would be hard to gauge in the slow month of August.

"Whether this is going to impact our practice, I really can't say until late September," he said. "We have enough of a pipeline that it's going to keep us busy for the foreseeable future."

As for going forward, cash may ultimately become king in a marketplace where highly leveraged lending deals are no longer available, Schwartz said.

"As the amount of leverage available decreases, then purchasers that have cash might re-enter the market seeing the opportunity," he said. "But it will certainly mean a slowing of the pace of transactions, because if there are fewer players, it's not the same kind of frenzy, and that will mean a reduction in [building prices]."

Wayne Heicklen, a partner and co-chairman of the real estate department at Pryor Cashman LLP, said there is no question that there "is a bit of a chill in the market.

"People are trying to find out, if they do deals, if they'll have to put in a bit more equity than they've traditionally had to put in over the past five years," he said, "or whether they'll be able to find a lender who's willing to go forward."

Heicklen said one client had closed on a land-use loan and then, after completing plans for an Upper East Side project, intended to acquire a construction loan. That deal may have gone sour.

"I think that they're very concerned about where the market is going right now, and I just saw ... there was a brokerage set up for the deal, so I think they're looking to get out," he said. "So there are people in a difficult position there, but this just happened [in early August], and before that, everybody was singing the same song: The market is good."