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### **Pricing and Market Changes:**

We are seeing some movement towards lower pricing on the four basic food groups (retail, office, industrial and multi-family)

- C+ or better for Multi's- 5.65% 3 year fixed, 80% LTV, 1.20 DSCR – NO PREPAYMENT PENALTY rolls to additional 3 year terms, western US, loan sizes from \$2,000,000 and up
- Commercial 5.9% and up – for 5 year terms, 3,2,1 prepays
- TIC deals quoted at 6.35 – 3 year deals, no prepay – these are lower leverage, up to 35 borrowers
- Mobile Home Parks – better quality, bank deal at 5.9% and up for a 5 year deal.

Credit is tightening for hotel construction, micro loans, and lesser quality assets. Every day we see a continuing flight to quality. We have plenty of money for bridge and distressed asset purchases.

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### **A “Low Brow” look at Property Values**

Nancy and I went to dinner recently with two couples who were talking about the recent symphony they attended. You know the “high brow” types that only watch Masterpiece Theater, go to depressing foreign films, and subscribe to the Economist.

Nancy and I, on the other hand, are not “high brow”. The TV shows, American Idol, House and Wife Swap are more to our liking. (I think Nancy secretly wishes for a husband swap.) I enjoy watching almost any sport on TV and our movie tastes are decidedly on action flicks without any meaning. We are definitely at the “Low Brow” end of the spectrum.

When it comes to looking at our lending environment, I am a “low brow” observer. I don't get caught up in the disastrous pricing of the latest securitization or the most recent WSJ article to figure out where the current market is. I rely on what I see and the opinion of folks on the front lines in our business. I survey our Investors, my appraiser buddies, sales

brokers, my borrowers and our readers to get a sense of the market.

Today I want to focus on the state of the sales market. So *(trumpets please)* here it here is. **Nothing is selling!** Of course any blanket statement like that will generate a response from a sales broker who will write me back and tell me that his volume is up and that he has plenty of transactions in progress. However, most lenders will tell you that the vast majority of their loans are refi's and the sales guys I talk to are quiet.

Sellers have not yet come to grips with the fact that buyers are not stepping up to buy stabilized, non-investment grade properties at a "5 or 6" cap anymore. The sellers that held out last year missed the top of the market and it is not coming back. There is no mystery to this. Most non-institutional buyers purchase properties on a cash flow basis. When the cost of financing rises, prices must drop to maintain the same cash on cash rate of return.

Now, borrowers could lower their expectations on rate of return but with all of the media predicting a collapse in prices that simply is not happening. Most borrowers are not lowering their target yield. In fact, given uncertainty in the markets, they are even raising their yield requirements. Combine that with a higher cost of money and you have a stalled market. The difference between the ask, and the bid on prices is the widest that it has been in years.

Consider this: If I could buy a property with a 5.50% loan a year ago and now I have to pay 6.50% for the same loan, I must purchase the property for 17.5% less to get the same cash flow.

The March 2007 10 year Treasury was around 4.55%. Middling quality commercial deals were getting priced by the conduit guys from as low as 95 over the Treasury to say 1.25 over in the heat of competition with as much as 10 years IO. Take the same deal today and in general, you get that deal priced in the low to mid sixes for a 10 year commercial property with lower leverage and little IO. Therefore, the buyer who wants the same cash on cash yield is going to pay less.

Please note: Multi-family properties will be less impacted than commercial because the gov't lenders like FNME are priced at levels consistent with last year even if they are a bit more conservative. So, the cost of financing in Multi's has not risen as much as commercial.

Also, as we have been saying, there has been a flight to quality. The cost of

financing is similar to last year for institutional quality transactions with lower leverage. So in theory, buyers of those assets should be willing to pay more. But, these buyers, I suspect are in the Wall Street camp in believing that the sky is falling and they are getting more and more conservative on the buy side and requiring higher yields. This also translates to lower prices but perhaps not in the 20% less range.

This brings me to a pet peeve of mine. When I got into the business, the concept of using a “cap rate” to value properties was foreign to the non-institutional buyer. Valuing real estate by the business school concept of “cap rates” or discounted cash flows was decidedly “high brow.” For me, prices were always tied to the cost of financing because I am NOT an all cash buyer. I consider cap rates as a measure but in the end I look at how a property will cash flow and the predictability of that cash flow. That is why, for example, on a personal basis, I have always been a big fan of middle level mobile home parks – very predictable cash flow and not the darling product of the institutional investors. On the other hand, no matter what the credit, I have been nervous about buying credit tenant deals. They sell at low caps on the theory that you have a coupon clipper for the next twenty years but the darling companies of today are the bankruptcies of tomorrow. (Think “Kmart”!)

To get this market moving, we need sellers who have smelled the coffee and accept the need to price lower to a market that has a higher cost of borrowing.

