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WARNING: The following is about the ninth draft of this article and the more I read it, the less interesting I find it. I suggest that you skip this one if you are short on time. I will try and be more pithy and amusing next week.

Joe

Understanding Credit Crunch # 3

It occurred to me as I read the usual spate of depressing articles how pervasive this credit crunch is and how quickly it hit us. This time the credit problems seem to permeate ever segment of business where previous "crunches" were isolated to a particular asset class.

When I first got into real estate, market changes seemed to occur slowly. Changing conditions were harder to see, took longer to have an impact and took much longer to recover. Consider the last three "credit crunches."

- **1988-1996** – Yes, I am talking about an eight year period. In the early 1990's we experienced a rolling credit crunch which seemed to start in Texas in about 1988 and spread throughout the country hitting California with a vengeance in 1991 or so. We didn't come out of it in CA until early 1996. (This was not a great period to be a mortgage broker) This crunch was generated by the closing of S&L's and over building. The problem was further exacerbated by government regulation which drove many of the remaining, healthy S&L's out of business. **From an originators perspective, this "crunch" took a long time to develop and stayed a long time.**
- **1998- 1999:** "just when I think I am out of it (a credit crunch), they drag me back in!" (Name the character and the film) The mid 1990's saw the maturation of the conduit business and by early 1998 we were closing so much business that the only limitation we had was the staff to process the deals. Then the Russian ruble hit the skids and the conduit business collapsed along with the rest of the markets. Nomura, First Boston and WMF conduits among others

took huge losses when they sold off their portfolios early. Some institutions held on and made a lot of money in mid 1999 as the market recovered. This was a credit crunch of very short duration compared to the crunch of the early 90's. **This was the first time that the commercial conduit business was impacted by issues in other segments of the capital markets.** However, since Wall Street only accounted for less than 17% of the loans originated, the impact was not even felt by many borrowers and by today's standards, seems rather benign.

- **2007 to ___** This crunch is once again from failure in another market segment and once again it is not, as of yet, a failure of the commercial real estate asset class. This time it is evidence of the fragility of the capital markets system as a whole. By some counts, the percentage of loans originated in the capital markets accounted for 40% or so of all loans originated in 2007. I think that number is low. I bet we have more than 60% of all capital for commercial real estate deals on the sideline at the moment.

In the latter part of the 1980's, Michael Milken (Mr. Junk Bond) predicted the integration of commercial real estate with Wall Street. As with junk bonds Wall Street provides a much more efficient secondary market for commercial real estate lenders. But, the Wall Street game always has a big downside. Wall Street **operates at warp speed** and a complete shutdown can happen on a moment's notice. (think stock market crash) Wall Street is composed of traders who don't care about the underlying assets. They only care about how much the "market" values the asset. Right now, no one knows what loans are worth. **Until the "mark to market" for commercial real estate loans stabilizes, the problems will persist.**

Integrating commercial real estate with Wall Street has forever changed the playing field for our business. Yes, for now, we still have capital from the regulated institutions but we do not have an infinite amount of money available. Further, a number of institutions have pulled out of the market because they can buy loans at higher yields than they can originate at. It is short sighted thinking but it is a growing reality.

The good news is that commercial real estate should be among the first markets to recover because our asset class seems to be performing well. When will that occur? Only "you know who" knows.

Reality Check - *No One Has All of the Answers.*

Last week I got a loan request for \$11,000,000 from a broker to provide construction financing for a solid local health club operator. I told the broker that my institutional program would not work because my investor only wants to finance plain vanilla commercial deals and health clubs are not plain vanilla (typically special purpose). I told him I might be able to do something in our bridge program which would be priced at 11% and 4 points or so. Well, I got this really hostile response: “this borrower is BANKABLE.” (Bankable was in 18 point type) I read this email late at night and frankly I was a little put off by this broker who I know is competent and should know better than to respond like that. Ok, if this guy is bankable, why are you talking to me? Financing anything right now other than a plain vanilla property is hit and miss. In a normal market, this borrower might easily warrant a well priced loan from a local bank and it still might for all I know. (I can’t know every lender in every market.) However, every lender has so much business today, why consider marginal property types when the “A” borrowers and “A” properties are plentiful. Mr. Broker – don’t shoot the messenger! “Can’t we all just get along?” (Who made that infamous statement?)

Follow Up:

- The Hotel and Golf Course Deal: legal snafu has delayed the disposition of this deal. As soon as I get a package, I will get it off to those of you that expressed an interest.
 - \$5,000 houses. I received many emails regarding last week’s article on this subject. I should have been more explicit on this. These properties are in locations that make Bagdad look like a holiday spot. By the time the foreclosure has taken place, these homes have been abandoned, stripped of plumbing, electrical and appliances. It is not uncommon to see 80% of the properties on the block vacant and boarded up. So, intrepid investors have to go in, rebuild the home, and lease it out. This is not an investment for the faint of heart. To find these homes, contact the sub-prime guys who made these loans. There are plenty of properties to go around.
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Weekly Bullet: *Underwriting Tightens*

Lenders are tightening underwriting guidelines. Anticipate lower LTV’s and higher DSCR’s. Non-recourse loans are disappearing - Lenders want to

see the borrowers butt in the deal. There is a trend towards more liquidity in deals and cash out is getting very hard to do. The 1.15 Debt Coverage Ratio no longer exists for multi-family in most situations. Min of 1.20.

- *Joe Forman, President and CEO*

