A Tale of Two Cities

How the Structured Real Estate Finance Business is Differentiated by Asset Classes

BY JAY ROLLINS, PRESIDENT, JCR CAPITAL

Commercial Assets

Commercial real estate lenders are currently perplexed and frustrated due to the ever-shrinking yields available in financing commercial properties today.

There was a time (3-5 years ago) when value-added commercial real estate lenders could command wide spreads on high leveraged, structured loans. These lenders were typically associated with companies that had an "A" rated balance sheet, and could borrow money cheaply in the commercial paper market.

These lenders would portfolio these loans and were comfortable being in the "spread business."

The assets of choice for these lenders were:

- A repositioning of a multifamily property
- Financing a partially leased office building
- Financing a run down shopping center in need of improvements to bring the property back to market

In the "old days," these lenders would fund 80% LTC and could charge Libor plus 350-450bs on their loans.

But, like big hair, the Yankees and a $1.50 per gallon of gas, those days are gone. The emergence of the CDO (Collateralized Debt Obligation) has changed the lending landscape.

The CDO market has "leveled the playing field," allowing all players with $50-100 million of equity to enter the new CDO lending business and take advantage of the new, lower cost-of-financing "technology." The loan of choice: the floating rate value added bridge loan.

Yet, while the CDO market lowered the cost of financing to levels even below where the "A" rated lenders used to borrow, other unintended consequences have followed.

Increased competition: This new technology has created more lenders in the value-added space, while the number of financable assets has stayed relatively the same.

Wider net of acceptable investments: Because there is more demand for the same assets, underwriting standards have relaxed. Marginal deals that had no home now have numerous suitors.

These two conditions have, for the moment, made the commercial real estate finance business more challenging and less profitable.

The Residential for Sale Market: Land, Lots and Condo's

In case you were on a one year sabbatical in Mongolia, the for sale residential market has dramatically declined recently. This decline happened faster than most people thought, and the decline in sales volume and prices has been much greater than most anticipated. For the first time in over seven years, a portion of the real estate market is in distress.

Homebuyers are walking away from deposits and not closing with homebuilders. Builders are walking away from deposits with developers, and not taking down their contracted lots. Land developers are then defaulting on loans. For the first time since 1990s lenders are dusting off their work out manuals.

Like all markets that experience distress (tech stocks, tulip bulbs), there lies an opportunity.

There is now ill-liquidity in the for-sale market. This illiquidity allows some lenders an opportunity for greater yields and less competition. Thus, for the lenders who have the knowledge and flexible capital to venture into land, land development and broken condominiums, the opportunities are back

Yet, this business is not for the faint of heart. It is difficult to take an "old school" conduit lender, who recently became a "CDO lender," into the world of zoning, plan approvals and residual land analysis.

One Lender's Reaction

At JCR Capital (the author is

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President of JCR Capital), a new value-added/opportunistic lender, we are tackling the "Tale of Two Cities Challenge" every day. We are fortunate to have the expertise and capital to play in either City, and to have the ability to move back and forth with ease.

JCR Capital's prior experience in land, land development and residential homebuilding is now being utilized, as we finance select land and condominium situations. While we also continue to finance the traditional value-added commercial properties that require rehab and lease-up, we have the advantage of being able to maneuver between markets.

Lenders and investors who can navigate both markets/Cities will be poised to create and maintain more client relationships, as they can work with sponsors who also see the opportunity to cross over into each market/City.

How long will this phenomenon last? Will the abundance of commercial capital and weaker credit, or a declining commercial market cause CDOs to implode? No one knows, but in the value-added real estate business, there is always a story du jour. Today the story is clear: A Tale of Two Cities.

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