

LAST WORD

As Good As It Gets?

Four compelling trends in the mortgage markets reveal a high degree of volatility. **By Jay Rollins**

If the real estate mortgage market were a chair, it would be supported by four legs: commercial real estate, single family, condo conversion, and land loans. Given the current state of the overall mortgage markets, that chair is barely standing. Three of its four legs have either fallen off or are wobbling, and only one leg remains stable — commercial real estate mortgage loans.

For further insight, let's review some compelling trends that have shaped each of the mortgage submarkets.

1. Condo conversion crisis

Not long ago, condo conversion loans were easy money. If you weren't in a condo conversion, you felt like the guy who never bought tech stocks in 2000.

Today, with few exceptions, no lender or holder of this paper is feeling good. Interest reserves are running out, 3% cap rates don't seem like such a great idea, and writedowns are beginning to occur. A good condo deal is about three things: basis, basis, basis. The music has stopped for lenders who underwrote to escalating residential values and to investor presales. Many of these investors also planned on using subprime loans.

For condo conversion players, the fourth quarter of 2005 was as good as it gets.

2. Single-family loan meltdown

At one point, the rule of thumb in qualifying for a single-family loan was, "If you can fog a mirror, you can get a loan," regardless of ability to repay. Lenders solved poor credit issues with higher rates. Low documentation loans, also known as "liar loans," saved the day for people with no income, making the American dream possible for just about everyone.

These loans were originated by commissioned mortgage brokers who sold the loans to mortgage companies, who then

packaged them and sold them to investment banks, who then packaged them and sold them as bonds to investors. As long as home prices kept rising, and owners could tap into home equity lines to make payments, all was well — but

not for long. When the subprime market eventually tanked, it left in its wake defaulted loans and a string of bankrupt mortgage companies that got caught holding inventory at the wrong time.

For mortgage bankers, realtors, homebuilders, and subprime investment banks, the fourth quarter of 2006 was as good as it gets.

3. Land loan roller coaster

As the condo market boiled over and subprime was hot, land began to attract capital. Land seemed fine because there was a strong demand to build the new homes and condos financed by the subprime market. The thinking was if the residential markets were good, land was too.

At the height of the land craze, any sponsor with a contract and PowerPoint presentation was a legitimate lending candidate. All that was needed was a contract, a development budget, and a compelling story about how the approvals would be obtained. The phrase "new paradigm" rang out once again, and land was deemed to be a standard real estate asset class.

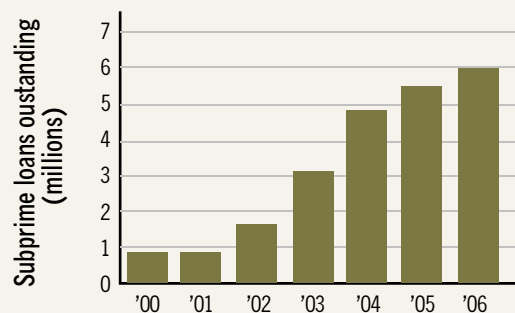
Lenders who went into the land business in 2005 and 2006 are now struggling with many of their land positions. Land has now joined the realm of the once-great condo conversion and subprime residential asset classes.

4. Commercial mortgage bravado

Despite turmoil in the other submarkets, commercial real estate mortgages remain relatively unscathed, with defaults at all-

SUBPRIME LENDING VOLUME SKYROCKETS

The subprime lending crisis has been compounded by a dramatic rise in subprime loans, which rose to 5.9 million at the end of 2006.



Source: Mortgage Bankers Association

time lows. In recent weeks, rating agencies have tightened subordination levels, causing an increase in spreads and the elimination of the 10-year interest only loan. The commercial collateralized debt obligation (CDO) market is also nervous, as subprime CDO bonds are getting marked to market.

Most professionals in the commercial mortgage market agree that at the outset of the third quarter of 2007, the top of the market is in the rear-view mirror. For this, there are multiple reasons. First, much of the money made in the commercial real estate seven-year bull run has resulted from cap-rate compression, versus real estate managers' ability to increase net operating income at the property level. Second, the consumer keeps spending despite higher debt ratios, and we have yet to see the consumer fallout from the declining housing market.

There are no dire predictions here, but we can expect cap rates to rise, asset prices to decline, and value-added transactions originated over the last 18 months that were structured to perfection are now in jeopardy. While only time will provide the final outcome for commercial real estate finance, we will all look back on the second quarter of 2007 and conclude that is as good as it got.



Jay Rollins is president of JCR Capital, a Denver-based real estate investment bank. He can be reached at jayrollins@jrcrcapital.com.