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Building Construction

Credit crunch expanding to commercial properties

The ongoing credit crunch in consumer mortgages is resulting in some tighter credit and increased underwriting standards in the commercial real estate market.



But as of the end of the third quarter of 2007, there was no evidence of increasing commercial defaults. The market for commercial mortgage backed securities – which provided low-cost, low-rate loans for commercial investors – dried up completely in the last two months of the third quarter, according to Adam Petriella, senior director of Marcus & Millichap Capital Corp. in Encino, Calif., an arm of Marcus & Millichap Real Estate Investment Services.

That meant borrowers were left with only traditional lenders who were themselves seeking higher loan-to-value ratios and were avoiding riskier loans.

Indeed, the Federal Reserve's most recent survey of senior lending officers found that one-quarter of U.S. financial institutions had tightened commercial lending standards since the previous quarter.

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Though some potential buyers are no longer in the market and appreciation rates have fallen somewhat, the bottom hasn't dropped out of the commercial real estate market like it has out of most of the residential lending market, Petriella says.

The tightening credit is likely to have different effects on different sectors of the commercial property market.

Multifamily Housing

Multifamily housing could have benefits and drawbacks from the current credit environment in what Petriella terms "a tale of two zip codes."

Some rental property owners, particularly owners of upscale, Class A properties, could get a boost from increasing rental demand from consumers who will be forced out of the housing market due to increasing mortgage rates.

A large percentage of adjustable rate mortgages are resetting from the low initial teaser rates to much higher market rates, resulting in higher payments that some homeowners can't afford. So some will re-enter the rental market.

Top-rated multifamily properties, the ones located in affluent areas and with strong occupancy rates, are likely to benefit from stronger demand and increasing property values.

"Multifamily is an outstanding investment," Petriella says.

Owners of less affluent (Class B and Class C) properties and of properties in less desirable areas are starting to see slower appreciation of their property values. The full effect of the current credit crunch may not be felt for a couple of years, as happened during a similar squeeze in the late 1980s and early 1990s, Petriella says.

Industrial and Office Space

Industrial and office properties have yet to be affected by the credit crunch, agree Petriella and Anthony M. Graziano,

managing director for the Coastal New Jersey office of Integra Realty Resources, a national property valuation and counseling firm with 55 offices across the country.

Office properties could see some pricing pressure if the economy slips into a recession, Graziano says.

Yet with tighter credit, it's harder to get funding to build new office properties, so the supply of office space is unlikely to increase, Petriella says.

Retail Space

Retail occupancy rates were still strong in the third quarter, Petriella says. Like office and industrial space, existing retail property benefits from "tremendous barriers to entry" from new competitors. So any fallout from the credit crunch wouldn't be felt for some time. Yet there were some indications that retail sales would be affected, which could limit the room retail property owners have to increase rents.

Falling home prices mean consumers have less home equity to use to make big-ticket purchases, like refrigerators and furniture, home improvements or many smaller purchases, Graziano explains.

Combine that with consumer cutbacks in shopping, and malls could struggle. The National Retail Federation predicts tepid holiday sales, with sales to increase only 4 percent over a year ago. Holiday sales in 2006 grew 4.6 percent compared to the previous year. Retailers were expected to cut prices just to get shoppers in the door. Wal-Mart started cutting prices for holiday items before Halloween.

"The expectation of slower retail rent growth, and less retail expansion due to consumer weakness, will make retail investments more risky, and hence prices will come down," Graziano says.

Hospitality Properties

Hotels, motels and other hospitality venues are likely to be weak for many of the same reasons, according to Graziano.

Some families have used home equity loans to help pay for vacations. That additional cash is no longer available.

"Tourism and travel are always affected by any restriction in consumer capital," Graziano says.

One factor aiding existing hospitality properties is that there isn't any new construction beyond what was already under way before credit tightened, Petriella says.

With the commercial market softer and riskier than it has been, commercial investors will be looking for lower prices to boost long-term returns, Graziano said.

"They pay a price depending on their expectation of future returns," he said. "The cost of debt, combined with the higher cost of equity (due to higher return requirements) will cause prices to flatten out or decline – or at best, appreciate more slowly."

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McLean, Koehler, Sparks & Hammond

11311 McCormick Road, Suite 100
Hunt Valley, MD 21031
410.296.6200

www.mksh.com

70 Thomas Johnson Drive, Suite 100
Frederick, MD 21702
301.662.2400