

Credit crunch will provide new opportunities

Those investors who don't rely on traditional financing have advantage



By Mike Hart

In 2007, we experienced a sea of change in the capital markets. The era of plentiful and inexpensive debt, which resulted in escalating values, ended abruptly last summer.

In stark contrast, we are currently facing a credit crunch derived from the widespread losses on residential mortgage, which has depressed values and significantly hampered the normal flow of the financing business.

The recent cycle in the residential markets and current distress in the credit markets represents an extreme example of supply/demand imbalance caused by an overly accommodating monetary policy. This can be traced back to moves by the Fed to lower interest rates to historically, and in retrospect possibly unnecessary, low levels to avoid a deeper recession after September 11, 2001.

The resulting building boom and speculation in residential development was largely due to increased demand driven by the availability of easy credit and adjustable rate financing to here-tofore unqualified buyers.

Beginning in June 2003, the Fed initiated a tightening course, and short term rates had moved up by 425 basis points by June 2005. By 2007, the increase in payments as the rates on adjustable residential loans began to move upward resulted in the beginning of widespread defaults in the residential credit sector. This has in turn lead to unforeseen levels of mortgage related investment write-offs.

The resulting rapid deterioration of the credit markets can be directly linked to increased fears of recession that have now caused the Fed to re-engage in a campaign of lowering rates in order to avoid exacerbating the slowdown.

Increasingly, activity in one sector of the capital market influences activity in other sectors. This has been particularly apparent as the subprime sector issues have reverberated through the entire capital markets. The increased correlation between the capital markets is largely due to the expansion of securitization into wholesales lending business practices spanning all asset types.

In comparison to the last real distress in the financial industry (that of 1998), the spreading of risk in various vehicles to a wider investor base has actually created a systematic problem. As a result of the widening of risk premiums in the secondary market, new business is severely constrained. This is because originators aren't sure how to price credit in consideration of real of perceived risks, and/or they cant free up capacity by profitably unloading performing loans, because potential buyers of such mortgage paper are struggling with the liquidation of positions, redemptions and write-downs associated with subprime portfolios.

Many investors are currently bearish, particularly those who have relied on liberal amounts of debt and aggressive terms to buttress purchases and enhance returns. The current malaise in the debt markets will take some time to be repaired as the banking system's balance sheets have been significantly impacted. The debt markets are still awaiting the ultimate trickle-through impact of the bulk of re-pricing of residential rate loans, and this re-pricing will be an ongoing process well into 2008.

As we have seen in previous cycles, current conditions provide an opportune time for careful purchasers to take advantage of the current dislocation and pending recovery in the market. Investors who do not rely on traditional capital sources can purchase property now at distressed levels on an all-cash basis or using private debt sources.

Minimum amounts of debt will be rewarded as the debt markets recover and property can be effectively leveraged or re-leveraged at accretive returns.

As 2008 unfolds we expect to see opportunities develop in which well-capitalized investors can step into fundamentally good real estate projects that are currently stalled due to the credit crunch. There will be opportunities to align with sponsors/developers that were granted high leverage loans that are now coming due and which they will seek to recapitalize in a challenging debt market.

There will also be opportunities to purchase from financial institutions seeking to reduce their exposure to problematic real estate and who will agree to sell properties at attractive yields and at discounts to replacement cost.

Purchasers with the vision to understand fundamental underlying value and the ability to close will reap considerable rewards as the capital markets recover and the expansion phase of the cycle repeats itself.

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