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[YESTERDAY'S DEAL VS. TODAY'S DEAL](#)

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With the capital markets in flux and major bond and stock indexes gyrating from one day to the next, real estate investors have been searching for information that can provide insight into the value of their holdings and potential acquisitions. The econometrically derived forecast of asset performance in TWR's Investment Outlook suggests some harsh declines in asset values moving forward. However, if one were to strip away that econometric approach and examine the aspects of potential deals themselves, one would still be bracing for declines in values.

How have the dynamics of real estate debt and equity markets potentially affected valuations over the past year? An interesting way to examine this question is to look at the structure of an actual retail strip center deal that was acquired with CMBS financing in early 2007, and determine how this deal would look if it were originated in today's much different capital market environment. Such an exercise can provide a concrete example of the dramatic capital market re-pricing on real estate valuations.

The table below shows the "Deal Yesterday" (early 2007 may seem like a long time ago for some investors!) in which the strip center was acquired for \$7.1 million and financed with \$5.95 million of mortgage debt (pooled in a CMBS transaction), representing a Loan-to-Value (LTV) ratio of nearly 84%. The deal's loan had terms that called for a 10-year maturity date and interest-only payments for the entire term. The loan's coupon was 5.74% for an estimated spread of 1.06% to the 10-year UST. The debt service coverage ratio on the loan was calculated at 1.26x on an interest-only basis, or 1.04x amortizing based on a 30-year payment schedule. The remaining cash flow after debt service provided an initial 7.85% cash-on-cash yield to the equity investor. Finally, the NOI cap rate on the deal was 6.08%.

	Deal Yesterday Originated Early 2007	Deal Today?	Change
Loan Amount	\$5,950,000	\$3,450,000	-42.00%
Value	\$7,100,000	\$4,935,000	-30.50%
LTV	84%	70%	-13.90%
Term (months)	120	120	
Amortization (months)	0	360	
Coupon	5.74%	7.88%	2.14%
UST	4.68%	3.82%	-0.86%
Spread	1.06%	4.06%	3.00%
Loan Constant	5.74%	8.70%	2.96%
NOI	\$431,806	\$431,806	0.00%
Debt Service	\$341,530	\$300,322	-12.10%
Debt Service (amortizing)	\$416,218	\$300,322	-27.80%
DSCR (current)	1.26	1.44	
DSCR (amortizing)	1.04	1.44	0.4
CFADS	\$90,276	\$131,484	\$41,208
Equity Yield	7.85%	8.85%	1.00%
Equity Yield Spread to 10-year UST	3.17%	5.03%	1.86%
Loan Amount at Term	\$5,950,000	\$3,018,969	-49.26%
LTV at Maturity	84%	61%	-22.63%
Cap Rate*	6.08%	8.75%	2.67%

* Band of Investment = weighted average cost of debt and equity.

While the deal may appear fairly aggressive from a loan leverage and structural standpoint, especially in today's lending environment, such structures were not uncommon during 2007's wave of CMBS loan originations. In fact, full-term interest-only loans comprised almost 38% of total origination volume, while loans with an underwritten LTV of 80% or greater accounted for approximately 8.6% of total origination volume, according to analysis of 2007 public conduit deals in the Trepp database. Meanwhile, the 6% cap rate on this deal was below the 6.5% national average on transactions closed during the time of its origination, according to Real Capital Analytics. Clearly, the metrics on a deal such as this will serve as a useful point of departure for looking at how valuations could change on similar richly-valued deals that were enabled by plentiful and attractively-priced mortgage debt.

Let's turn our attention toward outlining the set of debt and equity pricing assumptions that would be likely in today's capital market environment (see "Deal Today"). Given the lack of lending alternatives in the marketplace, let's say the buyers find a local portfolio lender that is willing to do the deal at more stringent terms than those of the CMBS lender just a year and a half ago. **Instead of financing over 80% of the purchase price, the lender will advance no more than 70% of this amount. Let's assume that the lender will require a minimum spread of more than 400 basis points (bps) over 10-year Treasuries—about 300 bps wider than just a year and a half ago.** The change does not appear unreasonable, given recent quotations in the marketplace: by point of comparison, CBRE Capital Markets recently reported that spreads on conventional 75% LTV, 10-year deals ranged from 350 to 550 bps. Furthermore, we assume that the lender will also require amortization on a 30-year schedule, bringing the loan payment constant to 8.7%.

Let's further assume that the buyers' required return expectations have increased in the new market environment. **Due to the lack of competition for similar deals, due to financing difficulties and higher perceived risk in the commercial real estate market, the buyers adjust their required return upward** by 100 bps. When calculated relative to 10-year Treasuries, this adjustment is roughly consistent with the magnitude of changes published in recent investor surveys such as Real Estate Research Corp's quarterly *Real Estate Review*.

What is the implication of this debt and equity re-pricing on the strip center's cap rate and valuation? To answer this question, we can derive the cap rate using the Band of Investment valuation approach, which derives the cap rate by calculating the weighted average cost of debt and equity capital. This approach is often used in appraisals of stabilized property to support the valuation by the direct capitalization method. **Using this approach, the cap rate becomes 8.75%, resulting in a value more than 30% lower than under the original deal!**

While this is a rather dramatic result, we should note that there are a number of restrictive assumptions when one uses the Band of Investment approach to derive the cap rate. Issues surrounding stabilized NOI and its future growth rate, the expected holding period of the deal, and amortizing loans are not brought into consideration under this approach; however, if one applies a modified Mortgage Equity valuation technique to the above example, which explicitly takes account of principal amortization, there is an implied value decline of approximately 26%.

So now we have an idea that our deal today could be priced some 26-30% lower than just a year and a half ago. Let's extend the example a bit further by looking at what the potential implications of the new capital market environment could be on the ability to refinance debt on the existing deal.

Suppose that the current debt market environment in terms of LTV requirements and average cap rates persist over the long-term. In other words: lenders are willing to extend first mortgage loans of only 70% of value in the future, and cap rates for this type of assets remain stuck at 8.75% (a rather pessimistic scenario at best) . How could the loan be refinanced using this LTV requirement and cap rate?

Given that the loan is interest only, NOI would have to grow by close to 5.6% annually in order to successfully refinance the loan balance at maturity (ignoring refinance costs). This is a pretty tall order, especially if the property is stabilized with long-term leases at current market lease rates. Even if NOI grew at 3% annually over this period, there would still be close to a \$1.3 million refinance shortfall (nearly 22% of the outstanding loan balance).

While this scenario is dire for a deal with these characteristics purchased in 2007, thankfully this scenario does not represent the entire market. Not every asset was purchased at the height of the market in 2007, so there will be a healthier refinancing cushion in place for much of the market. Furthermore, not every deal done at the height of the market was done with short-term debt. Much of the CMBS debt issued in 2007 came in the form of fixed-rate loans with ten year terms. The big refinancing risk comes in 2016 and 2017, though by then, years of a healthier economic environment and growing income will mitigate much of the refinancing shortfalls that would be seen if investors sought to refinance investments today.

TWR

Testimonials

"We have invited both Ray Torto and Bill Wheaton to speak at the largest Canadian Real Estate Conference held in Toronto. They are both world class presenters which reflects well on CBRE as a whole. During their visits we also host several private dinners with our clients which are extremely well attended and highly appreciated. There is no CEO in our country that does not rearrange their schedule to hear what these gentlemen are thinking at a given time."

E.M. Blake Hutcheson
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