

# Capital Markets Lender Forum

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## Key Trends

- Banks accounted for 40% of commercial lending volume during Q4 2012, compared to less than 30% one year earlier.
- Average LTVs for commercial loans inched up in Q4, to 65.9%, while multifamily-related LTVs dipped, to 66.5%.
- Spreads on CMBS bonds compressed during 2012, contributing to a significant increase in new issuance.
- The resurgence of bank and CMBS lenders may signal a return of liquidity to secondary markets.

## RESEARCH CORNER

Commercial real estate lending markets finished 2012 on a high note, with a flurry of deals closing during the fourth quarter. According to CBRE's analysis of loan closings, total lending volume increased by 18% in Q4 2012 over year-earlier levels. In addition to strong growth in multifamily lending from the agencies (up 36% from 2011 levels), banks and CMBS lenders contributed disproportionately to the overall gains. This offset a slight retrenchment in lending from the life companies, which were a linchpin of the commercial lending recovery in 2010 and 2011. Buoyed by strong demand for new acquisition credit, the refinance market appeared to improve, aided by low interest rates, gradually rising property net operating income, and an increase in the availability of mezzanine debt.

Commercial real estate fundamentals improved during the latter part of 2012, but the pace of recovery was mixed across the major property types. According to CBRE Econometric Advisors, multifamily occupancies rose above their long-term average to reach 95.2% nationally during the fourth quarter, prompting a 4.2% year-over-year increase in net effective rents. Growth in the demand for office and industrial space contributed to steady gains in occupancy, leading to national effective rent growth of 3.8% and 1.2%, respectively. On the other hand, the recovery in the retail sector continued to lag. While the demand for retail space improved in

2012, availability rates remained high, forcing landlords to continue to offer lower contract rents and concessions to attract tenants. Effective retail rents fell slightly in 2012—by 0.2%—marking the fifth consecutive year of declining rents nationally.

The economy has shown steady gains in private employment and encouraging signs that the housing market is finally turning a corner. However, the fourth-quarter preliminary GDP report showed a contraction in overall activity, which could portend further risks to economic growth if Congress fails to reach a budget agreement in the next few weeks. The Q4 GDP report showed a steep contraction in government spending, a result that could be repeated in future quarters as draconian budget cuts take place under sequestration. This could chill economic activity, as well as slow the recovery in commercial real estate fundamentals.

Despite these risks, we remain cautiously optimistic that the commercial real estate finance markets will continue to improve in 2013. The Federal Reserve's accommodative policy stance is likely to remain in place for some time, providing borrowers ample opportunity to lock in historically low interest rates. Over the course of 2013, overall liquidity is likely to continue to improve, as CMBS lenders and banks provide higher levels of lending capacity. With fewer constraints on property-type and market selection,

we believe these lenders will help improve liquidity to the secondary markets, where many borrowers faced fairly limited borrowing options over the past few years. Furthermore, we believe that the volume of outstanding distressed loans will continue to shrink in 2013, reflecting fewer new additions to the distressed pipeline, as well as an increase in dispositions by banks and special servicers.

the latter months of 2012. By December, the Index had reached a value of 122.

After the period of sharp retrenchment during the recession, the Index showed a somewhat volatile period of increases in lending activity through January 2012, before a decline during the first half of 2012. Since June, the Index has once again moved higher. To interpret

**Figure 1: CBRE Lending Momentum Index**

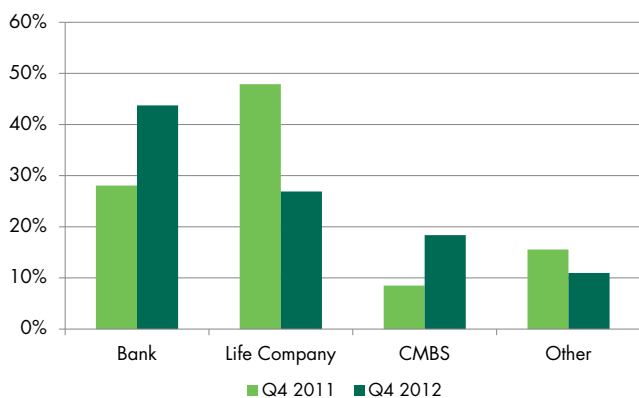


#### LENDING MOMENTUM IMPROVES IN Q4

Examining a proprietary database of loan data, CBRE Global Research and Consulting has created an index tracking the momentum of deal activity in the market for commercial mortgage loans. This index compares origination volume to a base level of 100, which reflects average lending activity during 2005, and is also adjusted for seasonal variation. The CBRE Lending Momentum Index in Figure 1 shows additional gains in commercial/multifamily loan origination volume during

the Index, one must place it in historical context. The Index stood at a value of 24 in March 2010, versus a high of 177 in August 2007. There was an 86% decline in lending volume over this 31-month period. Having reached this bottom, lending activity has been generally recovering since. In both November and December 2012, the Index matched its most recent peak, a value of 122 in January 2012. The Index has increased steadily since its most recent low of 87 in June, and was 40% higher than that value at year end. The Index was up 20% as of December, compared to activity a year earlier.

**Figure 2: Who's Lending on Commercial Properties?**



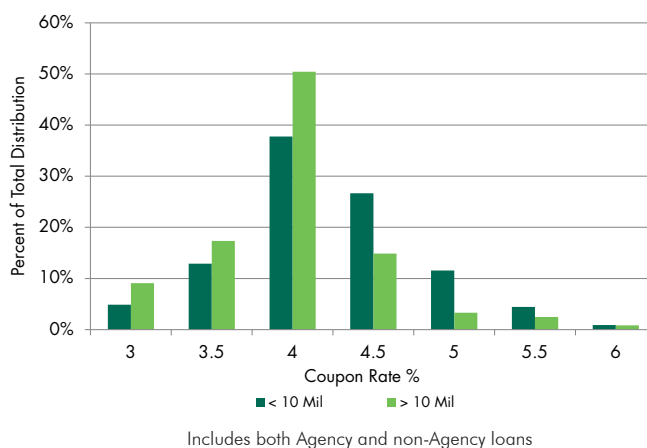
**THE LENDING LANDSCAPE**

As shown in Figure 2, bank lending revived during the fourth quarter of 2012, with 58 commercial transactions accounting for more than \$1.3 billion in volume. This was a significant increase in origination volume from the previous two quarters. Bank lending activity was fairly evenly distributed across property types and consisted primarily of acquisition and refinance loans. With the improvement in origination activity, banks accounted for more than 40% of commercial volume during Q4 2012, up from less than 30% one year earlier. As we noted in previous editions of the Lender Forum, banks have aggressively repaired their balance sheets through working out troubled real estate and development loans. As a result, banks are much better capitalized, and appear better positioned to extend credit on a selective basis.

Life companies' share of commercial mortgage originations was almost the mirror image of that of the banks during this period. Life companies' commercial mortgage originations topped \$800 million during the fourth quarter, accounting for 27% of total volume. Industrial and office transactions accounted for close to two-thirds of this amount. In contrast, during Q4 2011, life companies originated \$1.3 billion, accounting for nearly 48% of total originations.

However, in Q4 2012 CMBS issuers were finally able to capture a much larger share of overall origination activity. This was due to a rally in spreads that made CMBS lending products much more competitive with banks and life companies. CMBS issues accounted for 18% of commercial loan volume in Q4, up from less than 10% a year earlier and in parallel to the overall surge in the CMBS market during the final months of 2012. For the entire year, CMBS issuance volume totaled \$48 billion, up 48% from 2011. This reflected a strong fourth quarter of issuance, when spreads fell to some of their lowest levels since 2007.

**Figure 3: CBRE Capital Markets Coupon Rates, Oct.-Dec. 2012**



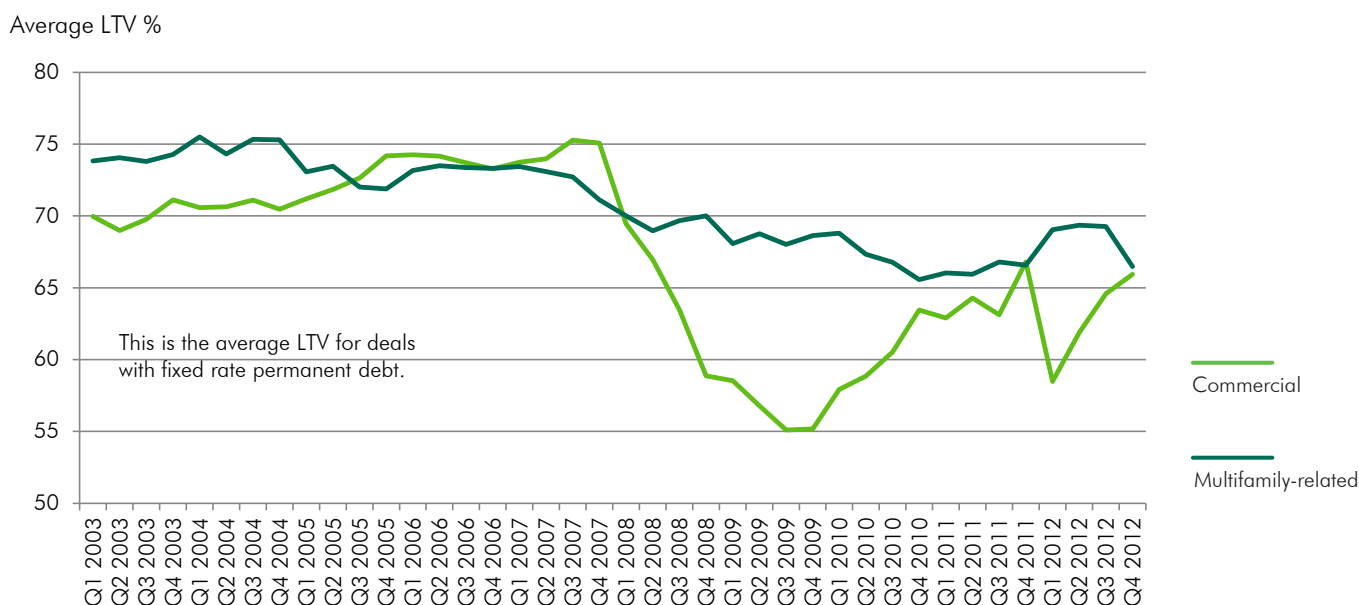
**COUPON RATES IN Q4**

Over the course of 2012, we witnessed a general downward shift in the coupon distribution for large and small loans alike, reflecting descending Treasury rates and loan spreads. As shown in Figure 3, a large number of borrowers were able to take advantage of very low coupon rates during the fourth quarter; more than 20% of loans carried a coupon of 4% or less, up from just over 14% during Q3. As in other recent quarters, smaller loans (those with an origination balance of \$10 million or less) tended to have a wider coupon distribution, but this has appeared to narrow slightly in recent quarters. A near majority of large loans carried a coupon rate of

between 3.5% and 4%, compared with 38% of smaller loans with an origination balance of less than \$10 million. In contrast, a larger proportion of smaller loans carried higher coupons. During the fourth quarter, 44% of loans below \$10 million carried a coupon rate in excess of 4%, compared with 23% of loans greater than \$10 million.

between 60% and 65%. This represents an improvement over the 55% low recorded during the recession in 2009, but is still substantially short of the 75% peak registered during the credit boom in 2007. It appears that lenders may be reluctant to grant much higher average LTVs until commercial real estate fundamentals demonstrate more sustained improvement.

**Figure 4: Average Loan-to-Value Ratio**

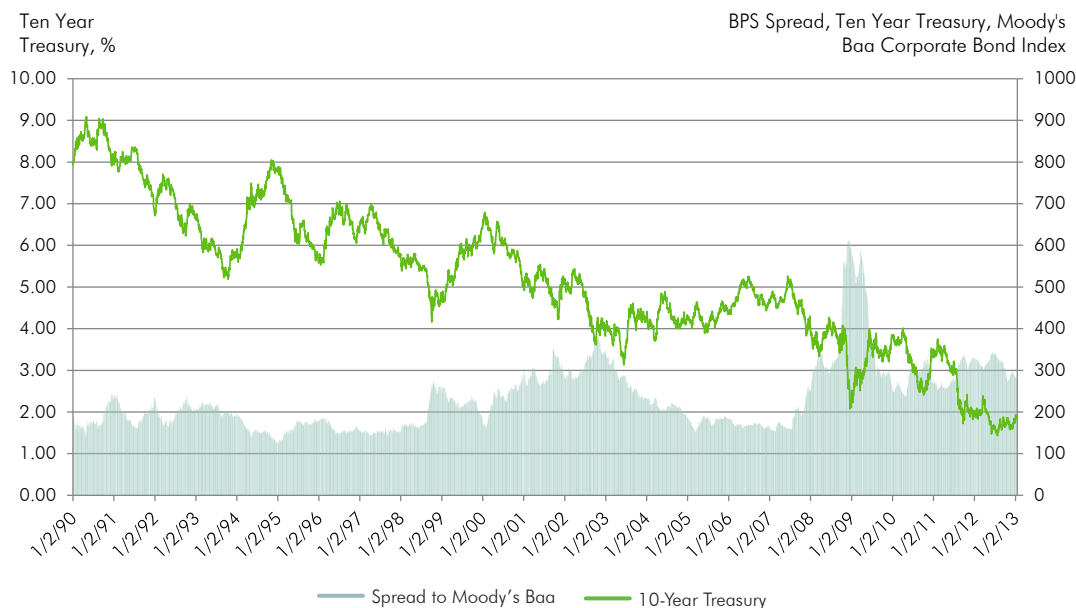


**COMMERCIAL LTVs CREEP UPWARD, MULTIFAMILY LTVs DIP**

In the final quarter of 2012, average loan-to-value ratios (LTVs) for commercial and multifamily loans converged in a similar fashion to what we witnessed a year earlier, as shown in Figure 4. Average LTVs for commercial loans reached 65.9% during Q4 2012, up from 64.6% in the third quarter. The Q4 figure was slightly below the average set one year earlier, which represented the highest average LTV since the end of the recession. While average commercial LTVs have been somewhat volatile from quarter to quarter, they appear to be stabilizing

After holding above 69% for each of the first three quarters of 2012, average multifamily LTVs dipped to 66.5% during the fourth quarter. This represented the lowest average multifamily LTV since mid-2011. Multifamily LTVs have remained stable in recent quarters, reflecting the influence of the agencies on overall loan origination and underwriting parameters. Since 2009, average multifamily LTVs have remained in the relatively narrow range of 66% to 70%. In recent quarters, the overall volume of loans has been fairly evenly split between acquisitions and refinancings.

**Figure 5: 10-Year Treasury vs. Spread to Moody's Baa Corporate Bond Index**



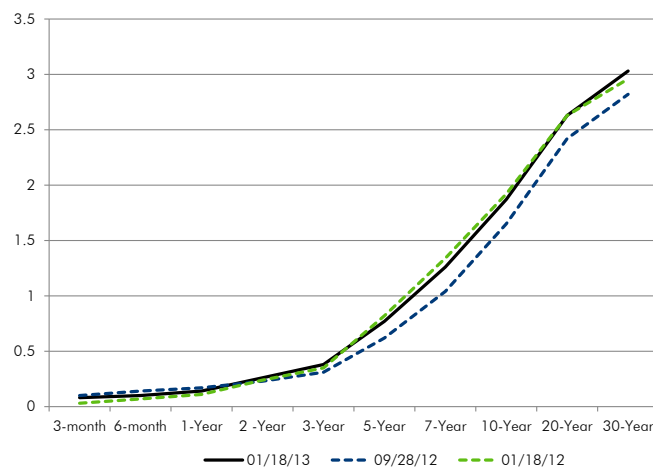
Source: Moody's Economy.com

**CAPITAL MARKETS TRENDS**

During the last three months of 2012, the Treasury market remained relatively stable, with benchmark 10-year bonds trading between 1.6% and 1.86%; the high end of this range was recorded in mid-December. By mid-January, the 10-year Treasury edged past 1.9%. Compared with the market close at the end of the third quarter, the Treasury yield curve shifted out by close to 20 basis points (bps) for securities maturing in 7 years or longer. However, the January Treasury yield curve closely resembled the curve registered one year earlier.

Most analysts do not expect a sharp sell-off in Treasury markets—at least over the short term—as rates are likely to fluctuate in a relatively narrow range. The case for the continuation of low interest rates reflects a number of factors, including sluggish economic growth in most regions of the globe, especially in the Euro Zone; the effects of fiscal austerity; low inflation expectations; a high degree of risk aversion among global investors; and continued quantitative easing measures by central banks.

**Figure 6: U.S. Treasury Yield Curve Percent**



In September, the Federal Reserve announced a new quantitative easing bond-buying initiative, the so-called "QE3" program, which targets additional Treasury and mortgage-backed securities purchases. The Fed also introduced a major policy change in December, by announcing that it will continue to make significant bond purchases to maintain low interest rates until the unemployment rate reaches 6.5%.

The Fed has justified its policy stance due to an extended period of modest employment growth and the lack of significant inflation. Employers added 155,000 non-farm jobs in December, according to the Bureau of Labor Statistics, bringing the total job increase to 1.8 million for all of 2012. While this figure nearly matched 2011's job gains, unemployment remained relatively high: the nation's unemployment rate held steady at 7.8% in December, compared with 8.5% a year earlier. Meanwhile, the Bureau's report on consumer prices indicated that inflation remained under control. In December, the Consumer Price Index was up 1.7% over year-earlier levels. Excluding food and energy prices, inflation registered a 1.9% increase.

Notwithstanding the Fed's increasingly aggressive attempts to stimulate economic growth, investors remain generally risk adverse. Although a year-end compromise was reached between the Administration and Congress regarding taxes, spending issues remain unresolved. It appears that uncertainty surrounding federal spending cutbacks continues to negatively affect businesses' and investors' willingness to take risks.

However, with historically low interest rates, investors have been under pressure to seek higher yields in credit instruments. Spreads on Moody's Baa-rated corporate bonds tightened by close to 20 bps over the course of the quarter. More importantly, the CMBS market closed 2012 on a high note, capping a year-long rally. Spreads on new-issue 10-year, AAA-rated CMBS bonds reached an average of 86 bps over the swap curve at the end of 2012, down from close to 110 bps at the end of the third quarter and more than 150 bps at the beginning of the year. The decline in spreads has made CMBS loan pricing increasingly competitive with other sources of real estate lending.

## KEY COMMERCIAL REAL ESTATE FINANCE TRENDS FOR 2013

### CMBS Market Maintains Momentum

A year-long rally in spreads made CMBS pricing highly competitive with banks and life companies by the end of 2012. As a result, CMBS issuance jumped by over 48% for the year, to reach a total of \$48 billion. Judging by January's strong performance, CMBS lending volume could be robust in 2013. Some observers are particularly bullish, with expectations that new issuance will reach the \$60-\$75 billion range, easily surpassing 2012's level.

Clearly, the market appears well positioned to capture an increased share of commercial lending, but questions remain regarding the short- and long-term industry trajectory. In addition to questions around the ability of investment-grade bond buyers to continue to support pricing levels in the market over the near term, some have concerns regarding the available capacity of B-piece buyers to support substantially higher levels of issuance. Furthermore, concerns remain about the final shape of regulatory reform, especially with regard to risk retention requirements and rating-agency governance under the Dodd-Frank financial reform law.

Nonetheless, the favorable pricing and performance in CMBS bonds continue to attract an increasing number of fund managers into the sector. Compared with other investments in sectors such as high-yield corporate bonds and mortgage-backed securities, CMBS bonds offer good relative value. Additional CMBS buyers could mean lower bond spreads, which would translate into lower lending rates for borrowers.

### Improving Liquidity Extends to Secondary Markets

During 2012, liquidity in the commercial lending markets continued to improve, as banks and CMBS lenders rejoined the action. Activity during the final three months

of the year was particularly strong. According to the Mortgage Bankers Association's commercial/multifamily originations index, overall Q4 2012 origination activity jumped by 49% over the same period a year earlier. A sign that liquidity deepened significantly, CMBS originations more than tripled, while bank originations surged by 68%.

Over the past three years, liquidity has been restored first to primary markets and high-quality property types and then gradually to secondary properties and locations. The resurgence of bank and CMBS lenders may indeed signal a broader return of liquidity to secondary locations. Banks and CMBS issuers generally have more flexibility as to which markets they lend in. In addition, real estate investors have been in search of higher-yielding investments in "B"-quality properties and secondary markets. With these sources of capital opening up to a greater degree, it is likely that pricing and investment volume in the secondary markets will benefit in 2013.

### **Distressed Loan Volume Wanes**

We expect the volume of outstanding distressed loans to moderate during 2013, continuing a trend that took shape during 2012. According to Real Capital Analytics, the volume of outstanding distressed deals fell by 16% over the year, as net additions eased while workouts increased.

This shift in the market reflects a number of factors that have emerged over the past several months. Large amounts of capital raised for distressed deals have helped support transaction volumes and pricing, inducing banks and special servicers to dispose of distressed assets more rapidly. Furthermore, the increased availability of mezzanine debt has helped increase refinance proceeds, allowing maturing CMBS loans to refinance at some of the highest rates since the beginning of the recovery. Finally, banks have aggressively shrunk their delinquent construction and development loan portfolios, leaving a reduced pipeline of deals to work out in 2013.

## MARKET OBSERVATIONS

### *Brian Stoffers*

President, CBRE Debt & Equity Finance  
Chief Operating Officer, CBRE Capital Markets

I was pleased to see many of our valued lender partners at the Mortgage Bankers Association's 2013 CREF conference earlier this month. I flew to San Diego expecting an upbeat, optimistic event, but the overall positive outlook far exceeded my expectations. Though our collective enthusiasm may be tempered by memories of our industry's recent past, unquestionably we are looking at a strong year ahead.

There is a lot of money seeking placement in real estate mortgages this year. Life insurance companies, CMBS platforms, commercial banks, agencies, bridge lenders—it seems virtually everyone is geared up for greater production in 2013.

Numerous life companies told us they could go to 75% LTV, and some will hold the resulting mezz piece themselves. A few told us they were reinstating their construction-to-perm programs. They continue to compete for and win some of the multi-housing loan opportunities. Rates remain at historic lows, despite the recent run-up in Treasury rates. Some report the retention of floor rates, but many have removed these.

The CMBS platforms are showing a level of confidence not seen in the past five years. Expectations for 2013 exceed \$65 billion, an approximate increase of 35% over 2012's activity of \$48 billion. In fact, by the end of the CREF conference, some CMBS lenders were boasting a market of \$80 billion or more! CMBS lenders show some optimism about being able to compete with life companies on a growing number of deals, as CMBS investor spreads have narrowed considerably. They also report eight to ten B-piece buyers in the market—the largest number we have seen in a long time.

The agencies remain very active and are extremely competitive for the deals they want most. Their

investments in multifamily mortgages remain very profitable. These activities allow the agencies to deposit billions into the U.S. Treasury annually, a fact seemingly little known outside our industry.

Commercial banks remain active, and their pricing is very competitive. A few of the larger banks can make ten-year balance sheet loans, though this is still a new practice for these entities. We see banks making more construction loans, as well as loans for asset classes beyond multi-housing.

Bridge lenders are also quite active, with expectations for another big year in 2013. Pricing is attractive, starting in the high-4% to low-5% range, a level historically not seen for this loan type.

I draw your attention back to Figure 1 of this report: the CBRE Lending Momentum Index. It is interesting to note that we are currently at the same level we were in the first quarter of 2007. Today's trajectory is not nearly as steep, but this is a strong indicator of just how far we've come in the last three years.

Most of our borrower clients report that they intend to be active buyers and sellers of real estate in 2013. The availability of accretive debt will certainly be a primary driver behind these transactions. We expect to see many institutional borrowers continue to utilize low-to-moderate, 50%-to-60% LTV debt. Borrowers have some concern about a rise in Treasury rates in 2013, but recognize these rates remain at very low historic levels. In general, borrowers seem more confident that short-term rates will remain very low, consistent with current guidance from the Federal Reserve.

Again, it was terrific to see so many of you in San Diego, and to see our industry continue to improve as we begin another year.



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\*US investment sales data as reported by RCA. Data does not include CBRE's individual property sales valued at less than \$2.5 million.



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