JUNE 2023

Credit CONUNDRUM

UNDERSTANDING THE IMPACT ON CRE

Current capital market conditions have property owners facing a loss of asset value between the point of loan origination and the point of maturity, largely due to economic pressure. While this has affected all asset types, the shift is most notable in the office sector, requiring property owners to recalibrate their decision-making process when determining whether to refinance or sell a property.

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REAL ESTATE SERVICES

THE *New* REALITY

Rising interest rates have impacted the amount of capital a building can secure, and an increasingly cautious lending environment is adding to the challenge.

AT LOAN ORIGINATION	$50M Purchase Price	6% Cap Rate	70% LTV = $15 M Equity $35M Debt	Debt Service @ 4.7%	$3M NOI and 8.81% ROE	**FINANCING GRANTED**
AT LOAN MATURITY	Value has Dropped to about $46M	Cap Rate no longer relevant	61% LTV = $22M Equity $28M Debt	Debt Service @ 7%	$3M NOI and 4.67% ROE	**FINANCING QUESTIONABLE**

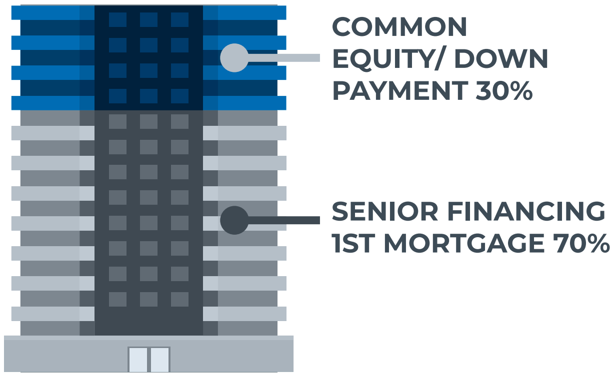
Building values are positioned to change in response to the capital markets. Property values adjust as the market stabilizes, but with a delay. With the market not yet showing signs of stability, determining value is difficult.

Twelve months ago in a low, stable rate environment, the loan-to-value (LTV) ratio was the dominant loan constraint. However, in this new market paradigm, the debt service credit (DSCR) ratio has become the more dominant loan constraint because DSCR numbers are more economically feasible than underwriting on LTV in the current environment.

THE *Refinancing* DILEMMA

COMMON SCENARIO

2018 FINANCING



Purchase Price		**$50,000,000**
Cap Rate		6.00%
Debt		$35,000,000
LTV	70%	
Equity		$15,000,000
NOI		$3,000,000
Debt Service @	4.7%	$1,678,809
CFADS		$1,321,191
ROE		8.81%

Expansionary Economy

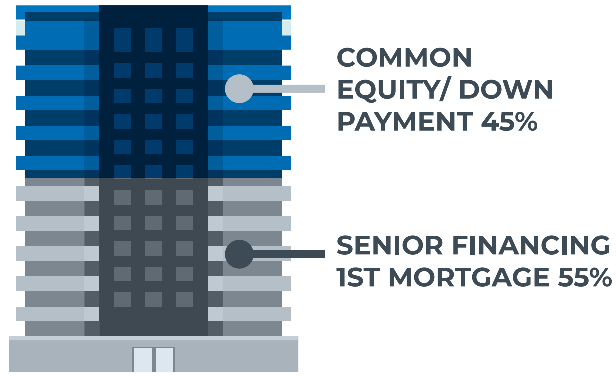
Favorable Credit Environment

Active Lending

Stable - Compressing Cap Rates

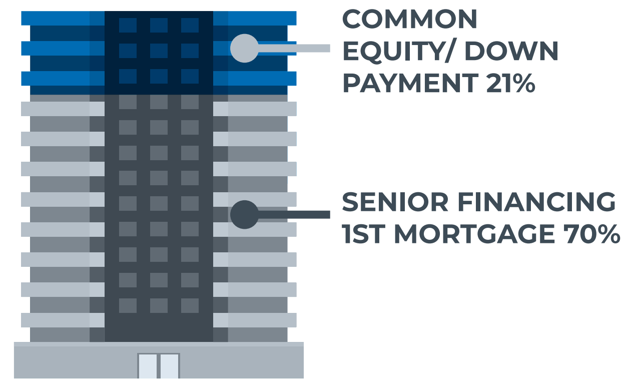
High ROE

2022-2023 OWNER REFINANCE



Refinance Value		**$46,153,846**
New Capital		**$6,702,619**
Cap Rate		N/A
Debt		$28,297,381
LTV		61%
Equity		$21,702,619
NOI		$3,000,000
Debt Service @	7.0%	$1,986,768
CFADS		$1,013,232
ROE		4.67%

2022-2023 OWNER SELL



Sale Price @AVG Commercial Cap Rate		**$46,153,846**
Cap Rate	6.5%	
Cost of Sale @	3.0%	$1,384,615
Net Sale Proceeds		$44,769,231
Less Loan Balance		$35,000,000
Equity		$9,769,231
Less Original Investment		$15,000,000
Gain/(Loss) on sale		($5,230,769)

Inflationary Economy

Tight Credit Environment

Cautious Lending

Increasing Upward Cap Rate Pressure

Constrained Debt Sevice Coverage/Falling ROE/Higher Cap Rates/Increasing Capital Requirement

THE FULL *Analysis*

The example provided walks through a hypothetical office scenario, as this sector is experiencing the most stress; however, other property types are susceptible to similar outcomes. A building that had a "perceived value" of $50 million at loan origination now has a lower perceived value; the value dropped in response to rising interest rates and economic uncertainty, despite unchanged NOI.

In commercial lending, interest rates are priced by taking a basis point spread, which consists of an implied real estate liquidity premium, then adding the spread to the 10 Year Treasury rate yield. In current conditions, this means the maximum loan amount that a building can secure has dropped due to a change in the average 10-year mortgage spread, which rose from 180 basis points in 2018 to 300+ basis points in 2022/2023. A chain reaction prompted an unfavorable environment for owners facing a loan maturity, putting immense pressure on cap rates, maximum loan amounts and return on equity (ROE).

Increasingly, owners must produce additional capital to get a refinance deal done, and in some cases, it doesn't make economic sense.

REFINANCE MATRIX - Feasibility of Financing Final Payment

Net Operating Income	$3,000,000
Loan Balance at Maturity	$35,000,000
Amortization	25 Years

Market Interest Rate	Max. Loan By 1.25 DSCR	Market Cap Rate	Est. Prop Value	Max. Loan at 70%
4.50%	$35,982,064	5.50%	$54,545,455	$38,181,818
4.75%	$35,080,496	5.75%	$52,173,913	$36,521,739
5.00%	$34,212,009	6.00%	$50,000,000	$35,000,000
5.25%	$33,375,179	6.25%	$48,000,000	$33,600,000
5.50%	$32,568,649	6.50%	$46,153,846	$32,307,692
5.75%	$31,791,125	6.75%	$44,444,444	$31,111,111
6.00%	$31,041,373	7.00%	$42,857,143	$30,000,000
6.25%	$30,318,218	7.25%	$41,379,310	$28,965,517
6.50%	$29,620,539	7.50%	$40,000,000	$28,000,000
6.75%	$28,947,266	7.75%	$38,709,677	$27,096,774
7.00%	$28,297,381	8.00%	$37,500,000	$26,250,000
7.25%	$27,669,909	8.25%	$36,363,636	$25,454,545

REFINANCING HEADWINDS

DSCR and LTV are currently at odds. In this scenario, the refinance amount was limited to $28,279,381as it was constrained by the DSCR. The owner faces increasing pressure to raise or invest additional equity to pay off the maturing loan at a time when values are resetting, and the ROE is declining. Because of the larger capital requirement to accomplish a refinance deal, the owner may now explore a possible sale to avoid a larger financial burden.

SELLING HEADWINDS

In this example, an owner selling under current conditions is likely to take a loss on the sale, but the bigger issue is finding a willing investor. A 7.5% cap rate would be required for the investor to achieve ROE in the same ballpark as when the loan originated – not an easy sell decision for the building owner.

In 2018, a borrower could easily secure financing with a 70% LTV at an interest rate around 4.7% and a DSCR of 1.25. The market was favorable for financing a mortgage and a building owner could expect a strong return.

In 2022, due to rising interest rates, negative valuation perception and stricter underwriting, the same borrower with the same building would require an additional $7 million in capital to secure refinancing because the maximum loan amount has dropped 20% or more. This not only impacts the ability to find financing, but also drops the LTV and the expected ROE. Although the Federal Reserve recently announced that they would pause rate increases for now to monitor the markets, the valuation adjustment phase in CRE is in the early stages.

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