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.
# 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.

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

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**

- **Common Equity/ Down Payment**: 30%
- **Senior Financing 1st Mortgage**: 70%

**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%
- **CFADS**: $1,013,232
- **ROE**: 4.67%

**2022-2023 OWNER SELL**

- **Common Equity/ Down Payment**: 21%
- **Senior Financing 1st Mortgage**: 70%

1. **Purchase Price**: $50,000,000
2. **Cap Rate**: 6.00%
3. **Debt**: $35,000,000
4. **LTV**: 70%
5. **Equity**: $15,000,000
6. **NOI**: $3,000,000
7. **Debt Service @**: 4.7%
8. **CFADS**: $1,321,191
9. **ROE**: 8.81%

**Gain/(Loss) on sale**: ($5,230,769)

- **Sale Price @AVG Commercial Cap Rate**: $46,153,846
- **Cap Rate**: 6.5%
- **Cost of Sale @**: 3.0%
- **Net Sale Proceeds**: $44,769,231
- **Less Loan Proceeds**: $35,000,000
- **Equity**: $9,769,231
- **Less Original Investment**: $15,000,000

**Inflationary Economy**

- Favorable Credit Environment
- Active Lending
- Stable - Compressing Cap Rates
- High ROE

**Expansionary Economy**

- Tight Credit Environment
- Cautious Lending
- Increasing Upward Cap Rate Pressure
- Constrained Debt Service Coverage/Falling ROE/Higher Cap Rates/Increasing Capital Requirement
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**

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

**REFINANCING HEADWINDS**

DSCR and LTV are currently at odds. In this scenario, the refinance amount was limited to $28,279,381 as 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.