

July 7, 2007

Clients & Colleagues,

Tumultuous – this is the best word to describe the credit markets over the past weeks and months. As you may have heard from others, credit is tightening, in a very uneven way.

In this last week, commercial mortgage backed security (“CMBS”) trading has experienced rapidly widening spreads, fewer buyers, and in some cases, no buyers for the riskiest part of a CMBS transaction. Widening spreads are causing CMBS lenders’ breakeven rate (the lowest interest rate at which they can write a loan and make a profit when they securitize it) to rise daily – 10 basis points last Wednesday, 45 basis points last Thursday, by one of our lenders’ accounting. Thursday and Friday, July 26 & 27ths markets were so tumultuous that many lenders ceased quoting interest rates or circling (“fixing”) a rate.

What are the causes? The subprime mortgage fallout started investors scrutinizing the credit analysis behind commercial mortgage backed securities, thinking that maybe the excesses of the residential subprime market may have seeped into the commercial arena. Buyers of the AAA bonds (least riskiest piece) criticized the rating agencies, who evaluate the relative risk of a CMBS bond, for being too lax in their analysis. Rating agencies began in February of this year announcing that they would be increasing subordination levels on future CMBS transactions. This means that a greater portion of a particular CMBS deal will have a lower credit rating than before: lower rated credit trades at a lower price and higher interest rate. If the CMBS lender made loans assuming a greater portion of their securitization would have higher credit ratings, then this change means they may lose money on the securitization. Buyers of CMBS bonds immediately started requiring higher yields on their investments as a result of the rating agency pronouncement.

In the last month, certain CMBS securitizations found lenders unable to sell large chunks (“tranches”) of the portfolio of loans that comprise a securitization. The buyers of the “B” or unrated tranches of the securitization have been “kicking out” loans that they deem to be too risky, and essentially telling the seller of the securitized transaction that they won’t buy any of the unrated tranche of the bonds unless those deals are removed. This action removes all of the present profit from that group of “kicked out” loans for the CMBS lender who originated the loans, and potentially results in losses from those loans.

Many of these “B” piece buyers have a business model where they would buy the unrated, highest risk portion of a securitized CMBS offering (“B pieces”). They would then package up a portfolio of these “B” pieces and re-securitize them (called a Re-pac), getting cash for their portfolio of CMBS bonds. This repackaged securitization is then sold in the Collateralized Debt Obligation (“CDO”) market, and is divided up into tranches and given relative risk ratings just like a CMBS bond. But buyers of these CDO’s are now saying, “how can a portfolio of debt consisting originally of unrated B

piece CMBS bonds now be combined into a CDO and re-rated with subordination levels that include investment grade tranches, when the underlying assets were all originally deemed to be below investment grade?” This portion of the CDO market has lost buyers, and has reduced the ability of the B piece bond buyers to turn their assets into cash, which results in a reduction in their ability to purchase further B pieces of future CMBS transactions. As a result, the B piece buyers are being much pickier and are requiring less risk in the CMBS bonds that they buy. And liquidity is severely curtailed.

What I am describing in the CMBS market has been happening since February. In the last week, credit markets generally became very uncertain. This uncertainty has come from news indicating that the subprime debt debacle is not anywhere near over, and is spilling into prime home mortgages – with delinquencies rising from prime single family borrowers. It is also coming from the corporate bond side, with financing for leveraged buyouts of companies pending merger (Alliance Boots, for example) finding insufficient demand. Interest rates on all debt except for the least risky - Treasury bonds – have risen in the last week. Spreads for the AAA Super Senior CMBS bonds – the least risky portion of the securitization – were up 25 basis points last week, and are still rising. Investors flocked to the safe haven of Treasuries, resulting in the ten year Treasury bond yield dropping on Thursday to 4.77% after having been at 5.09% two weeks prior. Bond buyers are skeptical of all debt perceived to be risky.

What does this mean for the commercial real estate investor?

Loan underwriting is now more conservative. Ten year full term interest only loans are not in the cards, unless you have a low leverage (under 65%) loan. Underwriting rent increases several years into the future to calculate today's net operating income is no longer acceptable. Interest rate spreads are rising among both CMBS lenders and life insurance companies – life insurance companies have to look at alternative investments, which include corporate bonds and CMBS bonds, whose rates have risen.

This turmoil will subside, and the markets will settle. I don't think we will see the really aggressive loan underwriting again anytime soon. In the long run, this turmoil and a move toward more prudent loan underwriting will help prevent overbuilding in the commercial property markets, which will help all of us in the industry.

On the positive side, we are still closing loans! Recent fundings include:

- 1) \$18,455,000 ten year loan with a couple years' interest only on a 50 room limited service hotel and 18 hot mineral springs in Pagosa Springs, Colorado, refinance with cash-out funded by Deutsche Bank in the midst of all this turmoil.
- 2) \$4,000,000 loan, low leverage, fully amortized over 20 years on a strip retail center which is completing lease-up, funded by one of our life companies, Assurant.
- 3) Portfolio of three multi-tenant class B industrial properties located in Denver, funded by Allstate Life. This portfolio also was completing lease-up and the loan

was funded with a low in-place debt coverage ratio for a strong repeat borrower.
The loan includes rights of release of individual properties in the future.

Feel free to call or email us if you have questions on financing feasibility of a project, or if you are in need of debt, or if you desire better explanation on today's mortgage market. We are good at navigating tumultuous times!

Best regards,

[Cynthia A. Hammond](#)

President

Churchill Commercial Capital, Inc.