



## **The Credit Meltdown of Summer 2007; How Will it Affect the Tenant-in-Common Industry?**

There are many interconnected causes for the credit meltdown of summer 2007 and there will be a number of associated consequences as a result. For those of us who are active as investors, brokers, or sponsors of tenant in common interests, two of these consequences will loom especially large; demand for and supply of available TIC product.

The first issue with which we must be concerned is demand for TIC product. As an industry, we are already facing flat or declining demand prior to the credit meltdown. We are all aware that exchange volume is down by significant numbers, reportedly by as much as 40% to 60% in some regions. Real estate brokers also report that a smaller ratio of their clients are using a 1031 exchange when they sell their property (taking advantage of the current 15% federal capital gains rate if they do not also have a lot of depreciation recapture to defer). While exchange volume has declined this year, overall transactional volumes have actually increased (we are, in effect, getting a smaller piece of a larger pie). But, now we face a more immediate problem.

Real estate is like a food chain. It requires entry-level investors to acquire the properties that existing investors are selling. In turn, those existing investors move up to acquire larger (or multiple) properties. Eventually, these investors may become candidates for TIC product as they tire of toilets, tenants and trash, desire to diversify their real estate investments, or look to increase their cash flow. However, every level of investor requires a steady, predictable supply of mortgage capital. The current meltdown has spread across all sectors of credit, from inter-bank lending, to commercial paper, to credit derivatives and most importantly, to every level of mortgage financing.

Buyers who are now in the market are experiencing this first hand; if the traders can't price risk, the lenders can't make loans. As mortgage financing has evaporated, escrows for to-be-relinquished properties are being delayed or canceled outright. While some sellers are reducing prices as a counterpoint to the increased cost of financing, most are holding firm, choosing to wait for their price rather than give in to what may be a short-term problem. Thus, our first and biggest risk; if investors can't sell their to-be-relinquished properties, they have no need for TIC product.

There is one, short-term, bright spot to this disruption. There are a number of exchange investors who have recently been successful in closing the sale of their relinquished property. They are often just now becoming aware of the impact of the credit meltdown on their ability to find financing for the replacement property that they wish to acquire. In many cases, they will simply be unable to find affordable financing. Fortunately, there is still a reasonable inventory of TIC product that secured financing prior to the meltdown. In many cases, this current inventory of product will be quite attractive when compared with non-TIC opportunities. However, once the existing inventory is gone it may be another story completely.

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The concept of a food chain continues as we look at the next risk; the lack of available TIC product. Regardless of the causes of the credit meltdown, the result is uniform; the global credit markets have lost the lubrication of liquidity (which is largely a lack of confidence) and have seized-up (or, melted down). When this happens across the entire credit spectrum, no one knows where to price any risk, or if, in fact, there are some risks for which no price is appropriate. In these circumstances, most suppliers of credit retreat to the sidelines. They cease accepting new applications or providing new loan quotes and, in some cases, they weigh the harm to their reputation from failing to fund committed credit obligations, versus the harm to their income statements and balance sheet by making loans that are underwater the second that they are funded. A much smaller number of lenders decide to stay in the market. But, since they can't price risk any better than other providers of credit, they price their loans at extreme levels; levels so high that they are happy to hold the paper until liquidity returns to the market and they can sell the paper (for those loans that are being quoted, spreads are up by 60% to 70% from two months ago).

Even these lenders, however, will not make credit bets on assets which might suffer significant impact if troubles in the housing sector drag the entire economy into recession. This means that 'vanilla', 'down the fairway' properties such as mid-level apartments, suburban office projects and industrial-warehouse properties will continue to find lenders (albeit, at very high rates compared with two months ago), while other property types that may be more susceptible to a recession, such as retail properties, auto-related properties, hotels and special-use properties may not find financing at any price in today's market. Unfortunately, the probable outcome is that until the capital markets re-liquefy, it will be very difficult for sponsors to bring out deals with cash on cash returns that are acceptable to investors, if they can bring them out at all.

As mentioned above, some lenders will choose not to fund some loans that are fully committed and rate-locked. This is of immediate concern to the entire TIC industry. If we cannot provide reliable, predictable products to our clients, with certainty of their ability to close, we will lose one of our strong advantages in the universe of potential replacement property. Lenders too need to be seen as reliable and predictable sources of financing with a certainty of execution for their borrowers. At some point, however, every lender recognizes that they must live to lend another day, even if that means failing to fulfill a commitment today.

Much has been discussed about material adverse change (MAC) clauses in commercial loan commitments. Everyone needs to remember that in an argument over MAC clauses, the lender always wins. They simply fail to fund. If the borrower disagrees with the lender's decision they must sue the lender. In the meantime, the borrower defaults on their escrow, the seller yanks the deal and the TIC investors who subscribed to that offering and who are past their 45-day ID period are left in a precarious position. Every rep should be having constant, serious discussions with sponsors regarding the status of their financing. If the financing is not already funded, if the deal can not withstand a significant increase in the loan spread (up 60 to 100 basis points at the time this was written), if the lender has not issued a written assurance of their commitment to fund, the reps and their investors should carefully evaluate the possibility that the loan will not be funded as scheduled and that the deal itself may collapse.

While supply of product is moot if there is no demand, it is likely that there will always be some level of demand for TIC product. The longer-term problem is the lag between the time that a TIC property is secured (put under contract) by a sponsor and the time that the offering actually

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comes to market. Eventually, the credit crunch will ease. As soon as it does, exchange investors will be able to close the delayed escrows of their relinquished properties as their buyer's loans are funded. These investors will be seeking replacement property with reasonable returns and a certainty of closing. It will be very challenging for sponsors to provide those benefits at that time unless they have some method to warehouse the properties in the short term (using floating rate financing, perhaps?), or an option with sellers allowing them to extend the escrow period until liquidity comes back to the market.

How long will it take to re-liquefy the capital markets? While, of course, no one knows the answer, it may be instructional to look at earlier credit crunches. Following the implosion of the Asian 'tiger' economies and the default by Russia on debt obligations in 1998, it took approximately six months for the markets to regain liquidity. Following September 11, it took approximately four months to return to normalcy. The Federal Reserve has already injected more liquidity into the banking system (\$62 billion as of August 11), than any time since September 14, 2001 when they injected \$81.25 billion following the 9/11 attacks. It seems reasonable to believe that, barring other shocks to the system, we will see normalcy return to the capital markets by the end of the year.

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