MORTGAGE BANKERS ANTICIPATE A BUSY 2020

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Image courtesy of Sonnenblick-Eichner Co.

Last fall, Sonnenblick-Eichner Co. arranged $13.8 million in refinancing and construction financing for the L'Horizon Resort and Spa, a luxury resort in Palm Springs, California. The five-year loan, which replaces existing debt and will fund a 24-unit expansion, features an interest rate of 50 basis points above the prime lending rate.

"The big change is that interest rates are lower than they were expected to be — they dropped pretty significantly in 2019 and remain at low levels today," he explains. "We're not seeing upward pressure on capitalization rates, and we see higher-than-expected loan volumes in 2019 carrying through into 2020. It is a great time to be a borrower."

Mortgage bankers echo that assessment.

"All in all, 2020 looks to be another active year, with all lenders having large budgets available to lend on commercial real estate and multifamily properties," says Susan Branscome, managing director in the Cincinnati office of NorthMarq, a mortgage bank that arranges some $13 billion in loans annually. "Lenders are all vying to obtain their share of a limited number of deals available."

Susan Branscome
NorthMarq

Market concerns

Despite the debt capital largesse and attractive interest rates, intermediaries still have worries. The plodding, record-long U.S. economic expansion is in uncharted territory, creating the sense that each day brings the country closer to a recession-triggering event, whether it's a massive selloff in the stock market, plummeting consumer spending, or some other financial or geopolitical shock.

In fact, the MBA highlights the World Bank's declaration that the global economy is already in a "synchronized slowdown" in a recently released report, titled *Where From Here?*

A chronic bid-ask spread between sellers and buyers remains a drag on investment sales, stymying acquisition loan activity. Sales of office, retail, multifamily, industrial and hotel assets in 2019 totaled $534.9 billion in 2019, a year-over-year decline of just over 1 percent, according to Real Capital Analytics, a New York City-based research firm that tracks deals of $2.5 million and greater.

Rising political uncertainty as the presidential election nears will likely diminish any rebound in the transaction market, at least temporarily, mortgage bankers concede.

What's more, in some cases, value-add apartment investors are failing to hit their rent growth expectations, suggesting that rental rates are peaking amid supply growth in certain submarkets (*see sidebar on page 34*).

Against that backdrop, debt providers have become more cautious, particularly in markets with robust multifamily and hotel supply pipelines. They're also wary of retail assets, especially those exposed to e-commerce competitors.

"We're generally having to cast a bigger net and answer more questions to get deals done," states Tucker Knight, senior managing director and head of Texas originations for commercial real estate service provider Berkadia in Houston, which arranged some $10 billion in loans in the state last year. "But it's still a very vibrant market with an immense amount of capital flowing into commercial real estate. Lenders are just a little more circumspect."

Tucker Knight
Berkadia

Market adjustments

Despite these pockets of concern, mortgage bankers and lenders are upbeat. By and large, property fundamentals remain solid, and few of the economic uncertainties are focused on the commercial property market, suggests MBA's *Where From Here?* report. In addition to low interest rates, the organization points out, growth in jobs, household formation and consumer spending portends good news for the sector.

"Clearly, we recognize that we're late in the cycle, and we're not expecting a significant boom in rent growth or property values — the cap rate compression game has about played out," declares Jack Gay, global head of commercial real estate debt for lender Nuveen Real Estate in Charlotte, North Carolina. "But we're also not calling for a dramatic downturn."

Jack Gay
Nuveen Real Estate

Among lenders, banks have adopted one of the most cautionary stances in recent months by becoming more selective when making construction loans, mortgage bankers report. While banks have typically focused on providing the loans to developers with whom they have a relationship, the practice became even more pronounced in 2019.

"The construction deals we're doing are usually the second, third or fourth transaction between X lender and Y borrower, where there's a rapport," says Jason Shapiro, managing director for the Aztec Group, a commercial real estate investment bank in Miami. "Banks won't do a deal with a new borrower, even if that borrower has good experience."

Additionally, banks no longer see the risk-reward appeal in providing a construction loan for 75 percent of a project's cost, Knight explains, when all they're going to reap is some 175 basis points over the 30-day London Interbank Offered Rate (LIBOR), which was 1.67 percent as of mid-January. Consequently, banks increasingly prefer to make loans to borrowers that also do treasury, deposit or other business with them, states Knight.

"The banks' thought process is that it's not making any money on the loan. The best-case scenario is that it merely gets paid back," continues Knight. "They're not making real estate loans per se anymore; they're making relationship loans."

Debt fund opening

That shift to reduce construction loan risk is providing the debt fund sector with more business, mortgage bankers observe. While debt funds have emerged as an alternative source for bridge loans over the past few years, that has not necessarily been the case in the Northeast, says Lauren O'Neil, senior managing director and co-head of the Boston capital markets office for JLL. Up until a few months ago, a number of aggressive banks were beating debt funds, which typically charge more for their capital, she points out.

But in 2019, JLL arranged a number of development deals with debt funds. One big advantage the funds offer developers is pari-passu funding, she adds. Such structures allow developers to funnel equity into the project intermittently with each loan draw, which enhances returns. Conversely, banks typically require borrowers to commit all equity up front.

"Debt funds are becoming more competitive, and they're offering more creative solutions," notes O'Neil. "Frankly, the returns sometimes end up being better even if borrowers have to pay a higher interest rate."

Lauren O'Neil
JLL

O'Neil also reports that banks began reining in interest-only terms midway through 2019. Instead of allowing interest-only payments for an entire seven-year or five-year loan, she explains, the banks are often shortening the provision to perhaps five or three years, respectively.