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2020 outlook for commercial real estate finance: Fundamentals remain strong in New England

Jeff Munoz
NorthMarq

Should local lenders start pulling back, borrowers are more likely to shop for a lender who can get meet their expectations. According to a new forecast from the Mortgage Bankers Association, U.S. commercial and multifamily mortgage bankers are expected to close a record $683 billion of loans backed by income-producing properties in 2020, a 9% increase from 2019s anticipated record volume of $628 billion.

In recent years, investors and borrowers have enjoyed a low rate environment as the economy has continued to strengthen. Property values have continued to appreciate, causing celebration amongst those who purchased at the peak of the recession and those who believe the economy will sustain growth for the foreseeable future. While the fundamentals continue to remain strong, lenders are starting to consider the possibility of a downturn. How much longer will this growth last? Simple answer: No one knows. What we know is the capital markets landscape is changing along with the industry's lending approaches.

Across the board, lenders are becoming increasingly selective about the types of assets they are lending on. Retail continues to be a shifting landscape as it proves to be a challenge to some of the more experienced operators. Lenders continue to remain aggressive on grocery-anchored retail properties in strong locations but are mindful of rents for in-line spaces. Office properties remain a volatile asset with many lenders requiring highly seasoned property managers to operate them. Greater Boston's industrial market lost 20 million s/f to conversions into multifamily and office properties. This helped accelerate rent growth, which we expect will increase loan volume on industrial properties throughout 2020. Multifamily properties continue to be the most sought-after property type given the high demand and rent growth seen around the New England markets. Fannie Mae, Freddie Mac, and FHA are expected to remain the largest capital sources for multifamily going into 2020 and beyond with initiatives focused on affordable and senior housing.

Borrowers who have built up significant equity throughout their ownership may start having trouble tapping into it. Fewer lenders are offering maximum leverage, especially on cash-out refinance loans, in anticipation of a potential drop or flattening in property values. Institutional lenders will still provide cash-out refinance loans around 65% but are reluctant to exceed this level unless proceeds are to be re-invested into the property.

Lenders are starting to notice an uptick in construction costs as they focus on decreasing developer profits as a natural barrier to future investments. Subcontractors have been raising their rates due to the multitude of projects underway since 2014. According to CoStar, subcontractor rates have increased 10% annually since 2014 and have climbed as high as 20% in 2019. The mayor of Boston, Marty Walsh, has vowed to address the shortage in affordable housing by raising $500 million over five years. These funds, which will be raised from a new property transfer tax, will be used to subsidize costs for affordable housing projects in the city.

Rates going into 2020 continue to perform similar to the year prior. The 10-year U.S. Treasury yield opened 2019 at 2.66% and dropped as low as 1.47% going into September and settled at 1.92% at the end of the year. So far in 2020, the 10-year Treasury has dropped 10 bps to its current level of 1.78% (as of January 21). Currently, the spread between the 2- and 10-year Treasury yields is approximately 25 bps. While this spread has widened in recent months, longer-term loans continue to be highly sought after in this volatile environment.

We are interested to see how the results from the recent mergers and acquisitions activity will affect the capital market landscape. The Massachusetts Division of Banks approved 12 mergers or acquisitions in 2019 alone. As the number of banks shrink, the asset bases of the ones remaining will increase. This will likely change loan programs in terms of loan amounts, proposed interest rates, and even property types. The big question is which ones will shift strategies and which will remain the same.

Despite lenders' growing anxiety over the direction of the real estate market, fundamentals remain strong in New England, especially Boston. It is a good time to be a borrower as local banks compete with national and institutional lenders for new opportunities. Should local lenders start pulling back, borrowers are more likely to shop for a lender who can meet their expectations. According to a new forecast from the Mortgage Bankers Association, U.S. commercial and multifamily mortgage bankers are expected to close a record $683 billion of loans backed by income-producing properties in 2020, a 9% increase from 2019s anticipated record volume of $628 billion.

Jeffrey Munoz is a vice president with NorthMarq, Boston, Mass.