Private Lenders Bulk Up

Borrowers rely on smaller players in a tightening credit market

By Clark B. Briner

Private-debt lenders are doing more of the heavy lifting in commercial mortgage finance, as the commercial mortgage-backed securities (CMBS) market contracts and the other large institutional lenders — banks and insurance companies — show continued reluctance to be weighed down with debt from any but the safest commercial projects.

With CMBS funding on the decline compared to 2015 and banks facing new capital requirements in an increasingly regulated environment, private debt is becoming more important for funding real estate acquisitions, development, recapitalizations and short-term to midterm credit facilities.

Those market conditions create financial pressures that make it harder for many prospective borrowers to put together commercial property deals that make economic sense, especially those who do business in small

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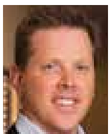
Illustration by Dennis Wunsch



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markets outside of the top 50 U.S. metropolitan areas. The combination of new CMBS risk-retention requirements, a decline in B-piece (higher-risk) buyer activity and increased bank-capital requirements for loans to all but the lowest-risk properties are all factors affecting commercial real estate market liquidity. These factors also are likely to negatively affect capitalization rates (the ratio of a property's income to its value) in the future.

There is tremendous pressure on banks to stay within regulatory requirements, not only the regulations contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which took hold after the financial crisis, but also the more recent capital regulations contained in Basel III — published by the Basel Committee on Banking Supervision.

Banks are struggling to maintain adequate returns on investment and net-interest margins in a low interest-rate environment by adding low-risk commercial real estate loans to their balance sheets, where lower risk-weighted capital requirements apply — frequently 50 percent risk-weighting versus 150 percent for higher-risk loans.

CMBS limits

Banks now issuing CMBS loan pools are under new constraints that increase balance-sheet risk and reduce flexibility. Among those constraints are the following requirements:

- **Beginning this year,** CMBS issuers are required to retain 5 percent of each loan in the risk position or sell to a B-piece buyer.
- **B-piece buyers** can no longer sell their holdings to any buyer. They must hold the bonds five years and may only sell to another qualified B-piece buyer after the hold period.
- **Recent CMBS B-piece buyer markets** have seen a significant decrease in buyer demand, which has decreased market liquidity.
- **Updated Basel III rules** will increase banks' capital requirements with a median increase of 22 percent and a weighted-average increase of 40 percent for swaps and bonds.
- **Regulatory requirements** could force banks to hold capital amounts exceeding a bond's market value for noninvestment grade, floating-rate and single-asset/single-borrower conduits, which would make CMBS investments uneconomical.

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wCompounding matters is the fact that billions of dollars in commercial loans are set to mature in the next 36 months and will add demand to the conventional-lending environment that is now more risk-averse. The Mortgage Bankers Association forecasts that $223 billion of commercial and multifamily mortgages held by nonbank lenders and investors will mature in 2016. The substantial volume of maturing mortgage debt appears to be having a moderate chilling effect on bank lending so far this year.

In order to fill the gap in financing for all but the lowest-risk properties, private debt-fund managers are expected to increasingly step into the market and provide first-position loans at interest-rate levels higher than the historically low levels of recent years. What this means for mortgage brokers is that there will be solutions for their clients' borrowing requirements, although it may take a little longer to source the capital and close the funding related to client transactions. Even brokers who enjoy good relationships with contacts at their regional banks may want to shop early for alternative lending sources, to be prepared in the event they discover that their banks are, in fact, tightening their lending practices.

Markets squeezed

The combination of debt maturities and reduced loans from conventional lenders to all but the best properties is likely to mean greater reliance on private lenders and greater pressure on a property market that has become accustomed to plentiful low-cost capital. Demand for private loans is increasing, as borrowers seek to refinance maturing debt and find loans to capitalize new projects.

These private lenders have historically provided short-term loans that borrowers often replaced with long-term bank or life-insurance company money when their credit rating or the performance of the property allowed it. That may change, however, as the real estate funding market grows more sophisticated at the institutional level and private lenders step in to make longer-term loans and recapitalizations.

In many cases, property owners won't have a choice other than borrowing from a private lender. At the same time, private-debt funds and lenders controlling capital will see an opportunity to move to a "risk off" (lower-risk) position compared to the so-called "hard money" lending of the old days. This may somewhat reduce the cost of capital through private-debt channels, although the cost will not mirror loan pricing by banks or life insurance companies.

While the market often views private debt, particularly bridge and mezzanine loans, as an exceedingly expensive source of funding, such loans remain a practical source

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of funding for many real estate developers and investors. Although the money might be expensive for a short period of time, the expense can be a better alternative than giving up equity in a project by bringing in additional investors. Once equity is relinquished, it is usually gone forever.

Weighing costs

More costly capital inevitably puts increased pressure on property economics. It hurts properties that were made profitable through low-cost financing and increases the need for fresh equity investments in many refinance situations. For all but the lowest-risk acquisitions, buyers can make operating pro formas work only by reducing the amount they pay for property.

As a result, market capitalization rates increase, unless the higher-priced debt is offset by cost savings elsewhere in a project. Higher cap rates might not deter investors in large gateway-city markets where low-risk, low-cost debt is available, but in many other markets, higher cap rates can be expected to push down property values in the near term.

One effect of this trend may be valuation pressure on value-add development projects and holdings in second- and third-tier property markets. With at least one-third of commercial real estate investing historically in the value-add space, this trend is chilling enough.

It is an even greater threat, however, to the commercial real estate industry, because of the trend in recent years of investors entering secondary markets — such as Salt Lake City; Nashville, Tennessee; Austin, Texas; and Raleigh, North Carolina. Investment funding could be vastly diminished in tertiary markets and metro regions that are not among the top 50 metropolitan statistical areas in the U.S.

To overcome this financing squeeze in smaller markets, mortgage brokers should encourage their clients to look for deals in "A" locations, even if the locations are in a tertiary market. Location has always mattered in real estate, yet during the recent upcycle, it mattered less. When the market starts to soften, good projects in great locations are far more likely to get financed than lesser projects in B locations. ■

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